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In The

Supreme Court of the United States

IRA NATHEL, TRACY NATHEL,
SHELDON NATHEL, and ANNE M. NATHEL,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

The Court of Appeals for the Second Circuit's decision that capital contributions excluded from gross income under Section 118(a) are not tax-exempt income for purposes of Section 1367(a)(1) is in direct conflict with the Supreme Court holding in *Gitlitz v. Commissioner*, 531 U.S. 206 (2001) that the items excluded from gross income under Sections 101-136 (including Section 118(a))[1] must be considered tax-exempt income for purposes of the Section 1366 adjustment of shareholder basis.

The Court of Appeals for the Second Circuit's decision that a shareholder contribution to capital of a corporation is not an item of income is also in direct conflict with the decisions of the Supreme Court in *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) and *Commissioner v. Kowalski*, 434 U.S. 77 (1977), which hold that, except for the fact that it is expressly excluded from gross income under Section 61(a) by Section 118(a), a capital contribution could be subject to income tax by Congress.

1) Whether *Gitlitz* requires the Second Circuit to rule that a shareholder's capital contribution to a corporation, excluded from income by Section 118(a), is an item of tax-exempt income for purposes of the basis adjustment rules of Section 1366(a)(1).

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[1] All references to "Section" and the "Code" refer to the Internal Revenue Code of 1986 as amended and effective in the relevant tax year, Title 26 U.S.C.

QUESTIONS PRESENTED – Continued

2) Whether the Second Circuit's exclusion of capital contributions from Section 61(a) income is in direct conflict with *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) and *Commissioner v. Kowalski*, 434 U.S. 77 (1977).

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners Ira & Tracy Nathel and Sheldon & Ann M. Nathel respectfully petition for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Second Circuit.

OPINIONS BELOW

The Petitioners filed timely petitions in the U.S. Tax Court contesting the tax deficiencies proposed by the IRS and claiming that the capital contributions to the two S Corps were required to be added to the basis of their obligations due from the corporations under the Section 1366 and Section 1367 basis adjustment provisions as of January 1, 2001, thus providing basis to their debt when repaid by the corporations.

The U.S. Tax Court sustained the Commissioner's determination of tax deficiency in an Opinion dated December 17, 2008 and entered March 30, 2009 (App. 33-53). The U.S. Tax Court and the Second Circuit Court of Appeals concluded that despite the holding in *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), which they argued was only applicable to Section 108(a), shareholder contributions to capital of an S Corp are not treated as items of income and, therefore, could not be treated as tax-exempt income to an S Corp under Section 1366(a)(1) and not treated as items of tax-exempt income for purposes of restoring a shareholder's basis in loans as required under Section 1367(b)(2)(B).

The Petitioners filed a timely appeal to the United States Court of Appeals for the Second Circuit and a decision was issued on June 2, 2010 for the Commissioner. A motion for rehearing en banc was denied. (App. 54-55).

Relying on a series of Supreme Court cases decided long before *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), the Second Circuit panel held that a contribution to capital excluded from gross income under Section 118(a) cannot be an item of income under the Sixteenth Amendment to the United States Constitution or Section 61(a) and, for that reason alone, the Petitioners' capital contributions cannot constitute "items of tax-exempt income" under Section 1366(a)(1).[2]

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[2] The Appeals Court panel held, relying on *Eisner v. Macomber*, 252 U.S. 189 (1920) and *Edwards v. Cuba R.R. Co.*, 268 U.S. 628 (1925), that a contribution to capital was not an item of income under the Sixteenth Amendment to the United States Constitution. The Second Circuit panel relied on its own holding that a capital contribution is not income under Section 61(a) and, for that reason, not an "item of income," stating:

> However, while the question whether "income" in Section 1366(a)(1)(A) includes capital contributions has not been resolved, courts frequently have addressed the scope of "income" as used in Section 61(a) and in the Sixteenth Amendment. Those cases indicate that capital contributions traditionally are not considered to be "income" and, therefore, should not be considered "items of income" under Section 1366(a)(1)(A).

Nathel v. Commissioner, 615 F.3d 83 (2d Cir. 2010).

JURISDICTION

The Tax Court's jurisdiction arose under Section 6212, Section 6213, Section 6214, and Section 7442 of the Code. The Second Circuit decision was entered June 20th, 2010, and Petitioners' timely filed petition for rehearing was denied September 20, 2010 (App. 54-55). A request for a 30-day extension of the 90-day period to file a petition was granted on December 15, 2010 by Justice Ginsburg. This petition is timely filed within the extension period, which expires on January 19, 2011. This Court has jurisdiction pursuant to 28 U.S.C. Section 1254(1).

STATUTES INVOLVED

Section 1366, Section 1367, Section 61 and Section 118(a) of the Internal Revenue Code (Title 26 of the U.S.C.), each enclosed in their entirety in the Appendix at App. 89-97 (Sections 1366-67), App. 56-57 (Section 61), and App. 85-89 (Section 118).

STATEMENT OF THE CASE

The three S Corps in this case, Wishnatzki & Nathel, Inc. ("W & N New York"), G & D Farms, Inc. ("G & D Farms"), and Wishnatzki & Nathel of California, Inc. ("W & N California"), were organized to operate food distribution businesses in New York, Florida, and California. The Nathels each owned twenty-five percent of the corporations and Mr. Wishnatzki owned fifty percent.

As of December 31, 2000, the Nathels each had a zero basis in their G & D Farms and W & N California stock due to the pass-through of losses that had decreased the basis in the stock to zero. They each had a basis of $112,547 in loans they had made to G & D Farms with an outstanding balance of $649,775 and a basis of $3,603 in loans made to W & N California with an outstanding balance of $161,250.[3]

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[3] In order to avoid duplication of income or loss (which the pass-through nature of S Corps is intended to prevent), the basis of the shareholders in the stock (and debt) of an S Corp is increased for income of the S Corp and decreased for losses of the S Corp.

For example: if an S Corp has two equal owners (A and B), each of which has a basis of 50 dollars in the stock of the corporation which has 100 dollars of taxable income, each owner pays tax on the 50 dollars of income allocable to it. If no distributions are made and if A then sells A's entire interest to X for 105 dollars, what should A's taxable gain be at the time of sale? If A's basis has been adjusted up for the 50 dollars of income, then A's basis is 100 dollars, and A pays tax only on the 5 dollars of gain above the adjusted basis. If the basis is not adjusted for the income, then A remains with a basis of 50 dollars at the time of sale and must pay tax on 55 dollars of income, the 5 dollar of actual gain, and a duplication of the 50 dollars of original income that remains in the corporation.

The same basis adjustment rules apply typically to tax-exempt sources such as tax-exempt life insurance proceeds (Section 101) and tax-exempt municipal bond interest (Section 103). If 100 dollars of tax-exempt income is earned by the corporation and A's basis is not adjusted, then the shareholder may wind up paying income tax on the tax-exempt income if and when A sells the S Corp stock to X or on liquidation of the S Corp. (Since the basis has not been adjusted, A then pays capital gains tax on the value of the income retained in the corporation.)

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In February 2001, G & D Farms repaid the Nathels' December 2000 personal loans in the full amount of $649,775 each, and W & N California repaid outstanding loans to the Nathels in the amount of $161,250 each.

In August 2001, the Nathels and Mr. Wishnatzki agreed to a plan of reorganization which included the liquidation of W & N California and the conveyance of full ownership of G & D Farms to Mr. Wishnatzki and full ownership of W & N New York to the Nathels. Pursuant to the plan of reorganization and in order to be released from certain personal guarantees, the Nathels were required to make capital contributions to W & N California in the amount of $181,396 each and capital contributions to G & D Farms in the amount of $537,228 each.[4]

Finally, the same rules apply in reverse. If the corporation incurs a 100 dollar loss, then each shareholder is allocated a 50 dollar loss, and each shareholder's basis is reduced by 50 dollars to prevent duplication of the loss. (If the shareholder's basis is not adjusted down for the loss, the shareholder would be able to both use the loss to offset income on the shareholder's tax return and again generate a capital loss on the sale of the shareholder's stock.) A shareholder can only take a loss on the shareholder's tax return to the extent the shareholder has basis in the S Corp, but basis for this purpose includes basis in debt of the corporation owned by the shareholder as well as the shareholder's basis in the S Corp stock.

The consistent operation of these rules as applied to tax-exempt income is the central issue in the case.

[4] In this case, the losses of G & D Farms had decreased the basis of the shareholders in the stock to zero, and additional

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In summary, each of the Nathels was repaid by W & N California the amount of $161,250 in February 2001 and contributed capital to the same corporation of $181,396 in August 2001. Each was also repaid $649,775 by G & D Farms in February 2001, and contributed $537,228 to the same corporation in August of 2001.

In calculating their 2001 taxes, the Nathels treated their capital contributions to G & D Farms and W & N California as constituting income – albeit "tax-exempt income" to the corporations for the purposes of the S Corp basis adjustment provisions of Section 1366(a)(1)(A).

Therefore, although the Nathels' basis in their stock previously had been reduced to zero and their basis in the loans they made to the corporations were also reduced to just above zero, the Nathels capital contributions restored their basis in the loans pursuant to the requirements of Section 1367(b)(2)(B) as of January 1, 2001.[5] Without such an increase in their

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losses decreased the basis of the shareholders in the debt of the S Corp even further, each as required by Section 1366 and Section 1367.

[5] In order to avoid duplication of losses, a shareholder's basis in an S Corp is adjusted down when the corporation's losses are passed through to the shareholder. A shareholder is permitted to claim tax losses from the pass-through of corporate losses only to the extent the shareholder has basis in the S Corp. The basis in the S Corp that is used for this purpose is the shareholder's basis in the equity held by the shareholder, and the shareholder's basis in any debt of the corporation held directly

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basis, the repayment of the Petitioner's loans in February 2001 would have, as the Second Circuit ruled, resulted in ordinary income in the amount repaid in excess of the reduced basis in each loan.[6]

The IRS contested the position taken on the Petitioners' tax returns that the capital contributions increased the Petitioners' basis in their G & D Farms and W & N California loans and instead stated that the capital contributions could only increase the basis in the S Corps' stock in the same manner as under the regime for "C" corporations (traditional taxable

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by the shareholder. Once the shareholder's basis in the stock is reduced to zero by the pass-through of losses, the basis in the debt is then reduced. Section 1367(b)(2). When the shareholder's total stock and debt basis in the S Corp is exhausted any additional losses are suspended until the shareholder has positive basis (subject to reduction on use of the suspended losses.) When the rules of Section 1367(a) require the increase in shareholder basis after a reduction in basis of shareholder debt, Section 1367(b)(2)(B) requires that this increase be applied first to the shareholder's outstanding debt as of the first day of the taxable year in which the basis is adjusted, before any of the basis increase is applied to the shareholder's stock.

[6] This regime of maintaining a unified basis system that permits the full deduction of ordinary losses is consistent with the pass-through tax and basis system of partnership taxation (Section 700 to 760) as it operates through Section 705. The partnership tax system permits the use of capital contributions for the deduction of losses and a matching decrease in total basis. This is in contrast to the bifurcated basis in stock and debt that is the outcome of following the ruling of the Second Circuit in *Nathel v. Commissioner*, 615 F.3d 83 (2d Cir. 2010).

corporations that do not operate under the S Corp pass-through tax regime.) See Section 1012.[7]

Because the Petitioners surrendered their stock as part of the reorganization plan, the IRS determined under the IRS theory of Section 1012 stock basis adjustment that they were entitled to a long-term capital loss in light of their increased basis in the stock, and were taxable on ordinary income on the repayment of the loans described above. The net effect of the IRS calculation was an increase in the tax owed by the Nathels in 2001 since the IRS claims the combined transactions generated ordinary income (when the low basis loans were repaid) and capital losses (since the contributions of capital created basis in the stock, and then the stock was surrendered for a total loss), instead of the elimination of both the ordinary income on repayment of the loan and the capital loss on surrender of the stock.[8]

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[7] "Section 1012 Basis of property-cost. (a) In general. The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)."

[8] Ordinary income is subject to tax in the year recognized, while capital losses may offset capital gains taxed at lower rates, or, if there are no capital gains, may be carried forward for use in later tax years.

REASON FOR GRANTING THE PETITION

Pursuant to Supreme Court Rule 10(c), the Supreme Court finds compelling a case in which a United States Court of Appeals has decided a matter on an important federal question in a way that is in direct conflict with relevant decisions of the Supreme Court.

The petition for Writ of Certiorari should be granted for the compelling reason that the decision of the United States Court of Appeals for the Second Circuit is in direct conflict with the Supreme Court's holding in *Gitlitz v. Commissioner*, 531 U.S. 206 (2001) that an item excluded from gross income by one of the Sections included in Sections 101 through 136 is an "item of income" for purposes of Section 1366 and Section 1367 basis adjustments of shareholder stock and debt in an S Corp.

The petition for Writ of Certiorari should also be granted for the compelling reason that the United States Court of Appeals for the Second Circuit's determination of what is "income" under the Sixteenth Amendment and the broad definition of income under Section 61(a) is in direct conflict with the leading decision by the Supreme Court in *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) that ALL "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers

have complete dominion" are items of income for purposes of Section 61(a) (defining gross income).[9] As applied in *Gitlitz*, although such items of income are excluded from gross income pursuant to Code Sections 101 through 136, they remain "items of income" for purposes of the S Corp basis adjustment rules of Section 1366 and Section 1367.

I. The Second Circuit Opinion Is In Direct Conflict With The Supreme Court's Holding In *Gitlitz* That All Income Excluded From Gross Income By Statute Is An "Item Of Tax-Exempt Income" For Purposes Of The S Corp Basis Adjustment Regime.

The Second Circuit's (and the U.S. Tax Court's) opinions are in direct conflict with that of the Supreme Court's holding in *Gitlitz*. Each Court has disregarded the plain meaning of the relevant statutes as construed by this Court in *Gitlitz*.

The Commissioner in *Gitlitz* made the identical argument with regard to cancellation of indebtedness income under Section 108(a), i.e., that since it was excluded from gross income under Section 108(a), it therefore could not be an "item of income" nor an item of "tax-exempt income." The Supreme Court rejected

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[9] The Opinion of the Court of Appeals for the Second Circuit is the only federal tax case that is a "negative cite" in the Westlaw Keycite system for *Glenshaw Glass*.

this argument, clearly stating that the plain language of the statute and statutory structure contained in Sections 101-136 of the Code required the Supreme Court to hold *that the statutes' exclusion of certain types of income from gross income does not change their status as "items of tax-exempt income" for purposes of the S Corp basis adjustment*:

> Moreover, Sections 101 through 136 employ the same construction to exclude various items from gross income: "Gross income does not include. . . ." The consequence of reading this language in the manner suggested by the Commissioner would be to exempt all items in these sections from pass-through under Section 1366. However, not even the Commissioner encourages us to reach this sweeping conclusion. Instead, the Commissioner asserts that discharge of indebtedness is unique among the types of items excluded from gross income because no economic outlay is required of the taxpayer receiving discharge of indebtedness. But the Commissioner is unable to identify language in the statute that makes this distinction relevant, and we certainly find none.

Gitlitz, at 213-214.[10]

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[10] The argument of the Commissioner in *Gitlitz* that cancellation of debt income is not a type of income because there is no economic outlay does not apply to Section 118(a) contributions to capital. Contributing capital is clearly an economic outlay by the shareholders (in this case) that is received by the

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The contribution to capital excluded from gross income by Section 118(a) falls squarely within this holding. Neither Section 118, nor any other section within Sections 101 through 136 during the relevant tax year, has a special provision excluding it from "items of income"[11] in general or for purposes of the S Corp basis adjustment required by Section 1366 and Section 1367.[12]

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corporation. The contribution to capital excluded from gross income by Section 118(a) falls squarely within the argument made by the Commissioner in *Gitlitz*.

[11] Like the other sections included in Section 101-136, Section 118(a) begins with language similar to "(a) General rule. In the case of a corporation, gross income does not include . . . " Like the majority of the other sections included in this list, complex exceptions apply to the general rule.

[12] After the Supreme Court ruling in *Gitlitz*, Congress amended Section 108 to include Section 108(d)(7)(A), which specifically excludes cancellation of debt income from "income" for purposes of the Section 1366(a) adjustment to shareholder basis. Sec. 402, PL 107-147, 3/9/2002. This provision in no way addresses any other item of income excluded from gross income under Sections 101-136. In addition, it was effective after the transactions in question in this case.

A) Relying On The Section 118 Language That "Gross Income Does Not Include" To Exclude A Capital Contribution From Being A Section 61 "Item Of Income" Is Erroneous Since The Supreme Court In *Gitlitz* Has Clearly Ruled That The Identical Language In Sections 101-136 Means That The Excluded Item Must Be An "Item Of Income" For Purposes Of Section 61(a).

Both the Tax Court and the United States Court of Appeals for the Second Circuit have erroneously construed the exclusionary language of the statute itself – "Gross income does not include . . . " – to conclude that a contribution to capital is not an item of income that Congress could, and in fact has,[13] treated as gross income for purposes of Section 61(a) and the S Corp basis adjustment rules. This construction of the language "gross income does not include" is in direct conflict with *Gitlitz*, which, looking at the identical language in Section 108(a), reached the diametrically opposite conclusion, i.e., that Congress would not exclude from gross income an item that was not otherwise includable in gross income under Section 61(a). The Second Circuit Panel clearly ignores the analysis of the Supreme Court when it stated that:

> The Petitioners make the novel argument that capital contributions constitute "items

[13] See Section 108(e) and Section 118(b).

> of income (including tax-exempt income)" for the purposes of Section 1366(a)(1)(A). They make this argument despite Section 118(a), which provides that "[i]n the case of a corporation, gross income does not include any contribution to the capital of the taxpayer." They argue that capital contributions are income, although tax-exempt income.

Nathel v. Commissioner, 615 F.3d 83 at 87 (2d Cir. 2010).

On the contrary, the Supreme Court had already considered the so-called novel argument in *Gitlitz* and reached the directly opposite conclusion regarding not only Section 108(a), concluding that the exclusion from gross income by Section 108(a) does not impact the fact that an item is an "item of income" for purposes of Section 61 and the S Corp basis adjustment rules of Section 1366, but that this also applies to any of the Sections 101-136 with the same statutory structure. The Supreme Court applied the same construction to the words "Gross income does not include . . . " and stated clearly, in *Gitlitz*:

> The Commissioner contends that this [Section 108] exclusion from gross income alters the character of the discharge of indebtedness so that it is no longer an "item of income." However, the text and structure of the statute do not support the Commissioner's theory. Section 108(a) simply does not say that discharge of indebtedness ceases to be an item of income when the S Corp is insolvent. Instead, it provides only that

> discharge of indebtedness ceases to be included in gross income.

Gitlitz v. Commissioner, 531 U.S. 206 at 213 (2001).

Similarly, none of the code sections included in Sections 101 through 136 excludes an item from being an item of income – instead the item is considered non-taxable, i.e., tax-exempt income for purposes of Section 61. As discussed above, the Supreme Court in *Gitlitz* has equated the structure of Section 108 to Sections 101-136 for purposes of determining whether something is an item of income for purposes of Section 1366. *Gitlitz v. Commissioner* 531 U.S. 206 (2001).

B) Capital Contributions Would Otherwise Be Gross Income If Not Excluded By Section 118(a) Just As Other Transactions In A Corporation's Own Stock Generate Taxable Income Or Loss That Is Excluded From Recognition By Section 1032.

Not only are capital contributions excluded from income by Section 118(a), but capital transactions resulting from the sale by a corporation of its own stock are excluded from "recognition" (but not excluded from "income") by Section 1032. If capital transactions by a corporation in its own stock were not otherwise items of income, these provisions would

not be required.[14] The Supreme Court in *Gitlitz* clearly reasoned that this means that the excluded item is an item of income. "If discharge of indebtedness of insolvent entities were not actually 'income,' there would be no need to provide an exception to its inclusion in gross income; quite simply, if discharge of indebtedness of an insolvent entity were not 'income,' it would necessarily not be included in gross income." *Gitlitz*, supra. As in *Gitlitz*, a contribution to capital is excluded from gross income under Section 118(a) because otherwise it would be gross income.

C) Since Even "Tax-Deferred Income" Is Included In "Items Of Income" For Purposes Of Section 1367 Adjustments To Basis Under *Gitlitz*, A Contribution To Capital That Is Tax-Exempt Income Must Clearly Be Included In "Items Of Income."

Furthermore, the Supreme Court in *Gitlitz* addressed another argument raised by the Commissioner, that the cancellation of indebtedness income

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[14] Section 1032 Exchange of stock for property. (a) Nonrecognition of gain or loss. No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. No gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option, or with respect to a securities futures contract (as defined in section 1234B), to buy or sell its stock (including treasury stock).

26 U.S.C. Section 1032.

was not tax-exempt income, but only tax-deferred, since tax attributes must be reduced to offset the exclusion from gross income of the cancellation of indebtedness income. The Court stated:

> Implicit in the Commissioner's labeling of such income as "tax-deferred," however, is the erroneous assumption that Section 1366(a)(1)(A) does not include "tax-deferred" income. Section 1366 applies to "items of income." This section expressly includes "tax-exempt" income, but this inclusion does not mean that the statute must therefore exclude "tax-deferred" income. The section is worded broadly enough to include any item of income, even tax-deferred income that "could affect the liability for tax of any shareholder." Section 1366(a)(1)(A). Thus, none of the Commissioner's contentions alters our conclusion that discharge of indebtedness of an insolvent S Corp is an item of income for purposes of Section 1366(a)(1)(A).

Gitlitz, supra, at 216.

Under *Gitlitz*, ***both*** tax-deferred income and tax-exempt income are "items of income" for purposes of the S Corp basis adjustment rules. Regardless of the fact that Section 108(a) and not Section 118(a) was the section of the Code ruled upon, the Supreme Court in *Gitlitz* has determined that the plain meaning of the statutory construction of the "gross income does not include" language contained in Section 108(a) is equally applicable to Section 118(a) for purposes of Section 1366 and Section 1367. "The

section is worded broadly enough to include any item of income, even tax-deferred income that 'could affect the liability for tax of any shareholder.' Section 1366(a)(1)(A)." *Gitlitz* at 216.[15]

While generally even "tax-deferred income" is included in income for purposes of the S Corp basis adjustment rules, the facts in this case involve a contribution to capital that is clearly tax-exempt because under no circumstances can this contribution of capital by shareholders (governed by Section 118(a)) become subject to income tax at a later date. Based on the plain meaning and language of the statute as further defined in Treas. Reg. 1.1366-1(a)(2)(viii), the contribution to capital is income to the corporation that is tax-exempt. The regulation clearly defines tax-exempt income for purposes of Section 1366: "For purposes of Subchapter S, tax-exempt income is income that is permanently excludible from gross income in all circumstances in which the applicable provision of the Internal Revenue Code applies." Treas. Reg. 1.1366-1(a)(2)(viii).

Based on this clear holding of *Gitlitz*, we request that the Supreme Court Grant Certiorari, Vacate the ruling of the United States Court of Appeals for the Second Circuit, and Remand the judgment of the

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[15] Section 1366(a)(1)(A): "(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and . . . "

United States Court of Appeals for the Second Circuit for further consideration, or, in the alternative, grant Certiorari for oral argument.

II. The Second Circuit Opinion Is In Direct Conflict With The Supreme Court's Holdings In *Glenshaw Glass*, 348 U.S. 426 (1955) And *Commissioner v. Kowalski*, 434 U.S. 77 (1977) As To The Definition Of Gross Income.

A) The Second Circuit Wrongly Relied On Abandoned Supreme Court Case Law To Find That Capital Transactions Cannot Be Items Of Income.

The Appeals panel concluded that a capital transaction does not create an item of income, relying almost exclusively on *Eisner v. Macomber*, 252 U.S. 189 (1920) and *Edwards v. Cuba Railroad Co.*, 268 U.S. 628 (1925).[16] Inexplicably, the Court of Appeals looked to several cases decided prior to *Glenshaw Glass* to conclude:

> However, while the question whether "income" in Section 1366(a)(1)(A) includes capital contributions has not been resolved, courts frequently have addressed the scope of "income" as used in Section 61(a) and in the Sixteenth Amendment. Those cases indicate that capital contributions traditionally are

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[16] The Court of Appeals cites *Eisner* four separate times.

> not considered to be "income" and, therefore, should not be considered "items of income" under Section 1366(a)(1)(A)." .... In determining whether capital contributions constitute "items of income (including tax-exempt income)," we look first to the traditional distinction between income and capital. *Eisner v. Macomber*, 252 U.S. 189 (1920).

Nathel v. Commissioner, 615 F.3d 83 at 87 (2d Cir. 2010).

Inexplicably, the panel ignored the fact that the limiting definition of income included in *Eisner* and *Edwards* had been clearly rejected by the Supreme Court in *Glenshaw Glass* and *Commissioner v. Kowalski*, 434 U.S. 77 (1977). *Glenshaw Glass* has become the touchstone for defining income for federal income tax purposes.[17] See for example *Commissioner v. LoBue*, 351 U.S. 243 at 246 (1956).[18] In case there is doubt that *Glenshaw Glass* broadened the definition of gross income and rejected *Eisner*, the Supreme Court clearly reiterated its position in *Kowalski*:

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[17] See text at footnote 31. *Commissioner v. Banks, II,* 543 U.S. 426, 125 S.Ct. 826 (2005); *Commissioner v. Schleier,* 115 S.Ct. 2159, 515 U.S. 323 (1995); *U.S. v. Burke,* 504 U.S. 229, 112 S.Ct. 1867 (1992); *Commissioner v. Indianapolis Power & Light Co.,* 493 U.S. 203, 110 S.Ct. 589 (1990).

[18] "We have repeatedly held that, in defining 'gross income' as broadly as it did in Section 22(a), Congress intended to 'tax all gains except those specifically exempted.' See, e.g., *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429-30"; *Commissioner v. LoBue,* 351 U.S. 243 at 246 (1956).

> *Jones* also rests on *Eisner v. Macomber*, 252 U.S. 189 (1920), but Congress had no reason to read *Eisner*'s definition of income into Section 61 and, indeed, any assumption that Congress did is squarely at odds with *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). See id. at 348 U.S. 430-431.

Commissioner v. Kowalski, 434 U.S. 77 at 94 (1977).

Furthermore, a prior panel of the Second Circuit in 1993 provided its own clear description of the evolution of the Supreme Court's definition of income for purposes of Section 61 and its predecessors, as follows:[19]

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[19] The Second Circuit Panel in *Collins v. Commissioner*, 3 F.3d 625 (2d Cir. 1993), explained the history of the Supreme Court definition of income best, as more fully provided:

> In the early days of the tax code, the Supreme Court recognized this problem and attempted to provide a more workable and perhaps somewhat more limited definition for the term. It defined income in Eisner v. Macomber, 252 U.S. 189 (1920), "'as gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets. . . ." Id. at 207 (quoting Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918)).
>
> It soon became evident that this definition created more problems than it solved. Under the Eisner formulation, questions arose as to whether gains from cancellation of indebtedness or embezzlement – which do not fall neatly into either the labor or capital categories – constituted gross income. See Stanley S. Surrey & William C. Warren, The Income Tax Project of

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the American Law Institute: Gross Income, Deductions, Accounting, Gains and Losses, Cancellation of Indebtedness, 66 Harv. L. Rev. 761, 770-71 (1953). Acknowledging the defects in the Eisner definition, the Supreme Court began to steer away from it. For example, in United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931), it held that gains from the retirement of corporate bonds by their issuer at less than their issuing price were includable in gross income. Justice Holmes, writing for the Court, reached this conclusion despite the fact that the gains were not clearly derived from either capital or labor. In so doing he adverted to the futility of attempting to capture the concept of income and encapsulate it within a phrase. See id.

The Court finally abandoned the stilted capital-labor formulation of gross income and jettisoned its earlier attempts to define the term in Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430-31 (1954). There the taxpayers had received treble damage awards from successfully prosecuting antitrust suits. They argued that two-thirds of these awards constituted punishment imposed on the wrongdoer and, under the gross income definition of Eisner, this punitive portion of the damages could not be treated as income derived from either labor or capital. See id. at 428-30. In rebuffing this proposition, the Court ruled the damage awards taxable in their entirety. It cast aside Eisner's definition of income stating that it was "not meant to provide a touchstone to all future gross income questions." Id. at 431. Instead the Court stated, "Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature." Id. at 429-30. The legislature intended to simply tax "all gains," which the Court effectively described as all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Id. at 430-31.

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> Acknowledging the defects in the *Eisner* definition, the Supreme Court began to steer away from it. For example, in *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931), it held that gains from the retirement of corporate bonds by their issuer at less than their issuing price were includable in gross income. Justice Holmes, writing for the Court, reached this conclusion despite the fact that the gains were not clearly derived from either capital or labor. In so doing he adverted to the futility of attempting to capture the concept of income and encapsulate it within a phrase. See id. *The Court finally abandoned the stilted capital-labor formulation of gross income and jettisoned its earlier attempts to define the term in Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430-31 (1955)]. (emphasis added.)

Collins v. Commissioner, 3 F.3d 625 at 630 (2d Cir. 1993).

> Since Glenshaw Glass the term gross income has been read expansively to include all realized gains and forms of enrichment, that is, "all gains except those specifically exempted." Id. at 430; see also *Commissioner v. Kowalski*, 434 U.S. 77, 82-83 (1977); Surrey & Warren, supra, at 771. Under this broad definition, gross income does not include all moneys a taxpayer receives. It is quite plain, for instance, that gross income does not include money acquired from borrowings. Loans do not result in realized gains or enrichment because any increase in net worth from proceeds of a loan is offset by a corresponding obligation to repay it.

Collins v. Commissioner, 3 F.3d 625 at 629-30 (2d Cir. 1993).

The reliance of the Second Circuit panel in *Nathel* on Supreme Court case law that has been clearly and repeatedly rejected by the Supreme Court, and the Second Circuit itself, provides the Supreme Court with a compelling reason to grant the petition. The lower courts cannot be permitted to disregard, with impunity, such clearly enunciated legal conclusions.

The reliance on *Edwards v. Cuba Railroad Co.*, 268 U.S. 628 (1925) for the principle that capital contributions are not an item of income must also be called into doubt as highly questionable since Congress itself concluded through the enactment of Section 118(b) that such capital contributions are gross income.[20] The Supreme Court in that 1925 case ruled that the contribution to capital by the Cuban government was a capital contribution and not income subject to tax under the Sixteenth Amendment.[21] *Edwards v. Cuba Railroad Co.*, 268 U.S. 628 (1925). Congress clearly believes that *Edwards v. Cuba Railroad* has been superseded by *Glenshaw Glass*, since the ruling in *Edwards v. Cuba Railroad* is in direct conflict with Section 118(b) as amended,

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[20] Section 118(b) was amended in 1986 to include contributions in aid of construction in gross income, and not exclude such contributions from gross income as previous law had permitted. P.L. 99-514, Sec. 824(a) (1986).

[21] The opinion made rather archaic differentiations between allocations to capital and allocations to income for capital accounting purposes in a manner somewhat similar to complex trust accounting principles.

which specifically *includes* in gross income contributions to capital by a customer to gain or expedite service by a utility, or as a contribution in aid of construction that benefits the contributor.[22]

If capital contributions were not income under the Sixteenth Amendment, could Congress have enacted Section 118(b), which taxes the same income held to be non-taxable by the Court in *Edwards v. Cuba Railroad. Co.*? Congress's ability to enact Section 118(b) is based on and supported by the Supreme Court's determination in *Glenshaw Glass* (1955) that the limited definition of income in *Eisner v. Macomber* (1920), and *Edwards v. Cuba Railroad Co.* (1925) could no longer be allowed to restrict Congress's ability to tax "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."

Not only are contributions to capital in aid of construction subject to tax, but a contribution to capital of the debt of the corporation is not tax-exempt, under Section 108(e)(6), since the corporation shall be treated as having satisfied the indebtedness

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[22] "Section 118(b). Contributions in aid of construction, etc. For purposes of subsection (a), except as provided in subsection (c), the term 'contribution to the capital of the taxpayer' does not include any contribution in aid of construction or any other contribution as a customer or potential customer." If *Edwards v. Cuba Railroad* were still the law, this section would clearly be unconstitutional, since the case clearly involved a contribution to capital in aid of construction.

with an amount of money equal to the shareholder's adjusted basis in the indebtedness. To the extent the basis is below the face value of the indebtedness, the corporation recognizes income.

B) Reliance On The Types Of Income Listed In Section 61(a)(1)-(15) Is Misplaced Since Many Types Of Section 61(a) Gross Income Are Not Specifically Listed In The Statute.

The *only* apparent stated reason for distinguishing the *Gitlitz* decision regarding Section 108(a) and the *Nathel* decision regarding Section 118(a) by both the Tax Court and the United States Court of Appeals for the Second Circuit is that a contribution to capital is not specifically listed as an item of income in Section 61(a)(1)-(15) and, therefore, is not income under Section 61(a) and for that reason cannot be an "item of tax-exempt income" for purposes of Section 1366 and Section 1367.[23]

Numerous items of income not specifically listed in Section 61(a)(1)-(15) have been held to be income by the Supreme Court. The clearest example is that punitive damages are not listed in Section 61(a)(1)-(15) or its predecessors, and are clearly gross income. See *Glenshaw Glass* itself. Transactions in a corporation's own securities can create gross income even prior to *Glenshaw Glass*, since the Supreme Court

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[23] See footnote 10, and related text.

held that the gain by a corporation from the purchase of its own bonds at less than par value is gross income, even though not listed in Section 61(a) or its predecessors. *U.S. v. Kirby Lumber Co.*, 284 U.S. 1 at 2 (1931).

Many other forms of 'accessions to wealth' that are not listed in Section 61 are gross income. Theft income is included in gross income. *Collins v. Commissioner,* 3 F.3d 625 at 630-631 (2d Cir. 1993). (In *Collins* the Second Circuit itself rejected any reliance on the capital or income definitions in defining income, stating: "The Court finally abandoned the stilted capital-labor formulation of gross income and jettisoned its earlier attempts to define the term in *Commissioner v. Glenshaw Glass Co.*" *Collins v. Commissioner*, 3 F.3d 625 at 630 (2d Cir. 1993).

Embezzlement income is likewise not listed in the Code, but is gross income. *James v. United States,* 366 U.S. 213 at 220 (1961). Benefits under Title VII of the Regional Railroad Reorganization Act of 1973 are not listed in Section 61(a) or elsewhere, but are gross income. *Martin v. Commissioner,* 90 T.C. 1078 at 1086-87 (1988).[24]

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[24] The language of the Tax Court clearly states the law in this area following *Glenshaw Glass* as many other courts have done:

> In general, gross income includes "all income from whatever source derived." Sec. 61(a). This provision is to be "given a liberal construction * * * in recognition of the intention of Congress to tax all gains except

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Even accessions to wealth that are not realized can be recognized as income under the Code's "mark to market" rules. Section 1256[25] and Section

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those specifically exempted." *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955). Correspondingly, statutory exemptions from gross income are to be given a narrow construction. *Commissioner v. Jacobson*, 336 U.S. 28, 49 (1949). See also *United States v. Wells Fargo Bank*, 485 U.S. 351 (1988) (estate tax case – "exemptions from taxation are not to be implied").

Martin v. Commissioner, 90 T.C. 1078 (1988).

[25] "Section 1256. Section 1256 contracts marked to market.

(a) General rule.

For purposes of this subtitle –

(1) each section 1256 contract held by the taxpayer at the close of the taxable year shall be treated as sold for its fair market value on the last business day of such taxable year (and any gain or loss shall be taken into account for the taxable year),

(2) proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain or loss taken into account by reason of paragraph (1),

(3) any gain or loss with respect to a section 1256 contract shall be treated as –

(A) short-term capital gain or loss, to the extent of 40 percent of such gain or loss, and

(B) long-term capital gain or loss, to the extent of 60 percent of such gain or loss, and

(4) if all the offsetting positions making up any straddle consist of section 1256 contracts to which this section applies (and

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475[26] are the primary examples. In each case the net gain or loss in certain transactions in securities are marked to market value and the net accession to wealth is taxable to the owner without the realization

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such straddle is not part of a larger straddle), sections 1092 and 263(g) shall not apply with respect to such straddle.

[26] Section 475 Mark to market accounting method for dealers in securities.

(a) General rule.

Notwithstanding any other provision of this subpart, the following rules shall apply to securities held by a dealer in securities:

(1) Any security which is inventory in the hands of the dealer shall be included in inventory at its fair market value.

(2) In the case of any security which is not inventory in the hands of the dealer and which is held at the close of any taxable year –

(A) the dealer shall recognize gain or loss as if such security were sold for its fair market value on the last business day of such taxable year, and

(B) any gain or loss shall be taken into account for such taxable year.

Proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain or loss taken into account under the preceding sentence. The Secretary may provide by regulations for the application of this paragraph at times other than the times provided in this paragraph.

of income as generally required by the Code. These mark to market provisions are items of income although not explicitly listed in Section 61(a).

In contrast to the holding of the United States Court of Appeals for the Second Circuit in ruling against the Petitioners, the Supreme Court in *Glenshaw Glass* concluded that Section 61 provides the broadest possible definition of gross income, defining income as " . . . [I]nstances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Glenshaw Glass v. Commissioner,* 348 U.S. 426 at 431 (1955).

Contributions to capital under Section 118(a) clearly fulfill the three requirements that the Supreme Court relied upon to define an item of income in *Glenshaw Glass*,[27] the same conclusion the Supreme Court made regarding cancellation of indebtedness income excluded from income under Section 108(a) in *Gitlitz*. If capital contributions were not otherwise included in gross income, and an "item of income" under Section 61(a), then there would be no need to exclude it from gross income under Section 118(a). The claim by the Commissioner in this case, just like the claim by the Commissioner in *Gitlitz*, must be rejected by the Court.

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[27] 1) Accession to wealth, 2) clearly realized, and 3) with taxpayer dominion and control. *Glenshaw Glass v. Commissioner,* 348 U.S. 426 at 431 (1955).

III. Policy Arguments For Granting Certiorari And Reversing The U.S. Court Of Appeals For The Second Circuit Regarding The S Corp Basis Adjustment Rule Of *Nathel*.

A) Reversing The Second Circuit Will Not Create A Double Deduction Or Other Harm To The Tax Collection System.

The reversal of the Second Circuit holding and the upholding of *Gitlitz* would force the adjustment of shareholder basis in an S Corp to operate as Congress intended, solely through the Section 1366 and Section 1367 rules. Unless the Court of Appeals ruling is overturned, the basis adjustment system for shareholders will be a bifurcated system – partially under the taxable corporation system of Section 1012, and partially under the S Corp system.[28] The correction of the current law in the Second Circuit from Section 1012 treatment to the S Corp system would only promote consistent treatment of taxpayers in similar economic circumstances. No other unusual tax impact

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[28] This bifurcated system – that permits the reduction of debt basis when losses are incurred but the increase in stock basis when a contribution is made creates an opportunity for tax attorneys to exploit. By timing the losses and capital contributions, a taxpayer can choose to reduce debt basis or stock basis on a net annual basis, depending on which is most advantageous to the taxpayer. Under the unified S Corp basis adjustment regime that the Petitioners propose is the proper reading of the statutes, the choice of outcome would not exist since basis would always be adjusted consistently. (The S Corp regime would reduce stock then debt basis, and reverses the order for all basis increases.)

would result. The taxpayers, like any shareholder in a similar situation, would be permitted to use basis to offset prior suspended losses and would not generate income on the repayment of debt to the extent the taxpayer has basis in the debt. The treatment of the capital contribution as a retroactive basis adjustment to shareholder debt is clearly in synch with Congress's intent to allow shareholders to reduce and/or eliminate the gain from debt repayment.

B) Congress Has Enacted Legislation That Includes Contributions To Capital In Gross Income.

Over many years, Congress has enacted legislation that indicates that Congress believes it has the Constitutional authority to tax capital contributions, and for that reason alone capital contributions must be income under Section 61(a).[29] Section 118(a) excludes most, but not all, shareholder capital contributions from gross income, while Section 118(b) includes non-shareholder contributions in gross income. Congress believed it was necessary to enact Section 1032 to bar tax recognition of capital transactions that are without question contributions to capital. Contributions to capital of the debt of a corporation are taxable to the corporation under cancellation of debt

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[29] As discussed above, the Courts have held that the Section 61(a) includes in income the full taxing authority of the Constitution.

rules of Section 10[illegible](e)(6). In addition, contributions to capital that qualify as "contributions in aid of construction" are not excluded from income, and are thus included in "gross income" for purposes of calculating a taxpayer's income taxes. Contributions in aid of construction are subject to tax since they are not excluded from income (and thus must already be gross income).[30]

C) The Rejection Of The *Glenshaw Glass* Broad Definition Of Income And The Use Of The Limited Definition Of Income Based On *Eisner v. Macomber* Is An Aberration – Westlaw Keycite Lists *Nathel* As The Only Federal Tax Case To Not Follow *Glenshaw Glass*.

There are only two federal cases cited in the Westlaw Keycite database as "negative citing references" for *Glenshaw Glass*.

The only case involving Federal income taxes is the Court of Appeals for the Second Circuit decision in *Nathel*.

Since the Supreme Court issued *Glenshaw Glass* in 1955, it has become the seminal case used to define

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[30] The only reported opinion addressing the tax treatment of Section 118(b) did not address either the constitutional or statutory income issue. See *Florida Progress Corp. v. U.S.*, 250 F.2d 747 (11th Cir. 2001).

income for Federal income tax purposes. It has been cited by four Supreme Court opinions since 1990,[31]

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[31] "The Internal Revenue Code defines 'gross income' for federal tax purposes as 'all income from whatever source derived.' 26 U.S.C. §61(a). The definition extends broadly to all economic gains not otherwise exempted. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429-30 (1955); *Commissioner v. Jacobson*, 336 U.S. 28, 49 (1949)." *Commissioner v. Banks, II*, 543 U.S. 426, 125 S.Ct. 826 (2005).

"Section 61(a) of the Internal Revenue Code provides a broad definition of 'gross income': 'Except as otherwise provided in this subtitle, gross income means all income from whatever source derived.' 26 U.S.C. §61(a). We have repeatedly emphasized the 'sweeping scope' of this section and its statutory predecessors. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429 (1955)." *Commissioner v. Schleier*, 115 S. Ct. 2159, 515 U.S. 323 (1995).

"The definition of gross income under the Internal Revenue Code sweeps broadly. Section 61(a), 26 U.S.C. §61(a), provides that 'gross income means all income from whatever source derived,' subject only to the exclusions specifically enumerated elsewhere in the Code. As this Court has recognized, Congress intended through §61(a) and its statutory precursors to exert 'the full measure of its taxing power,' *Helvering v. Clifford*, 309 U.S. 331, 334 (1940), and to bring within the definition of income any 'accessio[n] to wealth.' *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955)." *U.S. v. Burke*, 504 U.S. 229, 112 S. Ct. 1867 (1992).

"In determining what sort of economic benefits qualify as income, this Court has invoked various formulations. It has referred, for example, to 'undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.' *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). It also has stated: 'When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, "he has received income. . . .'" *James v. United States*, 366 U.S., at 219, quoting *North*

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and over 60 opinions by the Circuit Courts of Appeals. It has also been cited by over 60 Federal District Courts, over 100 full Tax Court opinions, over 400 Tax Court Memorandum Decisions, 17 IRS Revenue Rulings through 2007, and over 170 IRS Private Letter Rulings, including one as recently as November 2010, (and including nine that involve capital contributions).[32]

Since 2000, *Glenshaw* has been cited in eight full Tax Court opinions, while *Eisner v. Macomber* has been cited in only two (each of which cites *Glenshaw* favorably),[33] and in *both cases citing Eisner v. Macomber* and *Glenshaw*, the taxpayer's reliance on the limited definition of income used in *Eisner v. Macomber* was rejected, and *Glenshaw's* broader definition was used to include the income in gross income.[34]

American Oil Consolidated v. Burnet, 286 U.S. 417, 424 (1932)." *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, 110 S. Ct. 589 (1990).

[32] Data compiled using the RIA Checkpoint tax database.

[33] *Albert D. Campbell v. Commissioner*, 134 T.C. No. 3 (2010) (the attorney's fees payable from a qui tam award are included in taxable income); *Emmanuel L. Roco v. Commissioner*, 121 T.C. 160 (2003) (a qui tam award is included in taxable income).

[34] The Tax Court opinion in *Nathel* does not even cite *Glenshaw Glass* or *Eisner v. Macomber*. *Nathel v. Commissioner*, 131 T.C. 262 (2007).

IV. Because Of The Strong Similarity Of This Case To The Holding In *Gitlitz* And *Glenshaw Glass*, This Case Is A Strong Candidate For Reversal By GVR Or Summary Reversal.

As the Supreme Court did in *Youngblood v. West Virginia,* 547 U.S. 867 (2006), the Court can grant certiorari, vacate, and remand for reconsideration in the event a lower court decision is in direct conflict with a Supreme Court case decided on identical legal issues. Because the legal issues in this case have been fully discussed and resolved in the holding of *Gitlitz* and *Glenshaw Glass*, it is appropriate for the Supreme Court to grant, vacate, and remand this case.[35]

This case warrants an exercise of this Court's summary disposition powers. The administration of justice would benefit from an exercise of this Court's summary disposition powers in this case. There can be little question that the Court of Appeals misunderstood the statutory construction of the words "gross income does not include" and the definition of income itself under §61(a) of the Code. This Court often summarily reverses when a court of appeals simply misunderstands the Court's precedents. See, e.g., *Presley v. Georgia*, 558 U.S. ___, 130 S.Ct. 721 (2010); *Spears v. United States*, 555 U.S. ___, 129 S.Ct. 840 (2009). It also does so where the lower court's decision

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[35] See also "The Supreme Court's Controversial GVRS – AND AN ALTERNATIVE", *Aaron-Andrew P. Bruhl,* Michigan Law Review, Vol. 107:711 at 727 (2009).

was unreasonable. See, e.g., *Porter v. McCollum*, 558 U.S. ___, 130 S.Ct. 447 (2009). Thus, it would be appropriate for the Court to summarily reverse so here.

The Court has also granted the writ, vacated the judgment, and remanded to allow the Court of Appeals to reconsider in light of precedent, see, e.g., *Webster v. Cooper*, 558 U.S. ___, 130 S.Ct. 456 (2009), or to give the lower court another try in light of new understanding, see, e.g., *Youngblood v. West Virginia*, 547 U.S. 867 (2006). This Court issues a GVR to conserve "the scarce resources of this Court that might otherwise be expended on plenary consideration" and to "assist[ ] the court below by flagging a particular issue that it does not appear to have fully considered . . . " *Lawrence v. Chater*, 516 U.S. 163, 167 (1996). Here the Court's resources could be conserved by summarily reversing the lower court's judgment or, in the alternative, issuing a GVR order in light of *Gitlitz v. Commissioner*; *Commissioner v. Glenshaw Glass*, or both.

CONCLUSION

Based on the clear holdings of *Gitlitz* (2001), *Glenshaw Glass Co.* (1955), and *Kowalski* (1977), regarding the broad definition of income for purposes of Section 61(a), we request that the Supreme Court grant certiorari, vacate the United States Court of Appeals for the Second Circuit, and Remand the

judgment of the United States Court of Appeals for the Second Circuit for further consideration, or, in the alternative, grant certiorari for oral argument.

Respectfully submitted,

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IRA NATHEL, TRACY NATHEL, SHELDON NATHEL, ANN M. NATHEL,
Petitioners-Appellants,
-v.-
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Docket No. 09-1955-ag

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

615 F.3d 83*; *2010 U.S. App. LEXIS 11244*; *2010-1 U.S. Tax Cas. (CCH) P50,443*; *105 A.F.T.R.2d (RIA) 2699

February 3, 2010, Argued
June 2, 2010, Decided

COUNSEL: HUGH JANOW, Pearl River, NY, for Petitioners-Appellants.

TERESA T. MILTON, Attorney (John A. DiCicco, Acting Assistant Attorney General, Steven Parks, Attorney, on the brief), Tax Division, United States Department of Justice, Washington, DC, for Respondent-Appellee.

JUDGES: Before: KATZMANN and RAGGI, Circuit Judges, and KOELTL, District Judge.*

OPINION BY: JOHN G. KOELTL

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* The Honorable John G. Koeltl, of the United States District Court for the Southern District of New York, sitting by designation.

OPINION

JOHN G. KOELTL, District Judge:

The petitioners, Ira and Tracy Nathel and Sheldon and Ann M. Nathel, appeal a decision of the United States Tax Court (Stephen J. Swift, *Judge*) upholding tax deficiencies assessed by the Commissioner of Internal Revenue (the "Commissioner"). On appeal, the petitioners argue that certain capital contributions they made to two S corporations, of which they were shareholders, should be treated as items of "tax-exempt income" to the corporations for the purpose of restoring, pursuant to 26 U.S.C. § 1367(b)(2)(B), the petitioners' previously reduced bases in loans they made to the corporations. The petitioners contend that as a result of their restored bases, they received no ordinary income when the S corporations repaid the petitioners' loans. Alternatively, the petitioners argue that because they made the capital contributions to obtain releases from personal loan guarantees made to one of the corporations, the capital contributions should be deductible as ordinary losses incurred in a transaction entered into for profit pursuant to 26 U.S.C. § 165(c)(2).

We conclude that the petitioners' capital contributions do not constitute "tax-exempt income" to the S corporations and, therefore, that the petitioners are not entitled to increase their bases in their loans. We also conclude that because the petitioners have not met their burden of showing that the primary purpose of their capital contributions was to obtain

releases from their loan guarantees, the petitioners are not entitled to deductions from ordinary income pursuant to § 165(c)(2). Therefore, we affirm the Tax Court's decision.

BACKGROUND

The following facts are based on stipulated facts that the parties submitted to the Tax Court.

Ira and Sheldon Nathel[1] (the "Nathels") are brothers who, along with Gary Wishnatzki, organized three corporations that elected to be taxed under Subchapter S of the Internal Revenue Code (the "Code"), 26 U.S.C. §§ 1361-1379. "Subchapter S allows shareholders of qualified corporations to elect a 'pass-through' taxation system under which income is subjected to only one level of taxation." *Gitlitz v. Comm'r*, 531 U.S. 206, 209, 121 S. Ct. 701, 148 L. Ed. 2d 613 (2001) (citing *Bufferd v. Comm'r*, 506 U.S. 523, 525, 113 S. Ct. 927, 122 L. Ed. 2d 306 (1993)). S corporation profits are not taxed on the corporate level; instead, they are passed through as taxable income to shareholders on a pro rata basis. 26 U.S.C. § 1366(a)(1)(A); *see also Gitlitz*, 531 U.S. at 209.

In addition to profits, an S corporation shareholder is also taxed on any gain from the shareholder's sale of S corporation stock, which gain is calculated as the

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[1] Ira and Sheldon Nathel filed joint tax returns with their wives, who are also petitioners in this case.

amount realized from the sale in excess of the shareholder's basis in the stock. *See* 26 U.S.C. § 1001(a); *Craven v. United States*, 215 F.3d 1201, 1204 (11th Cir. 2000). A shareholder's basis in stock is generally the price paid for the stock if purchased from a third party or the amount of the shareholder's capital contributions if the stock is received in exchange for capital contributions. 26 U.S.C. § 1012; Treas. Reg. § 1.118-1 (1960).

Because S corporation profits are passed on to shareholders to be taxed at the individual level, to avoid the double taxation of a corporation's profits, the Code permits shareholders to increase their bases in a corporation's stock when the corporation receives certain "items of income described" in § 1366(a)(1)(A). § 1367(a)(1)(A); *Gitlitz*, 531 U.S. at *209*. Similarly, any losses or deductions that are passed through from an S corporation to shareholders reduce the shareholders' bases in stock in order to prevent the double deduction of those items. § 1367(a)(2)(B); *Gitlitz*, 531 U.S. at 209. If the deductions passed through by the corporation to a shareholder exceed a given shareholder's remaining basis in stock in any tax year, the excess deductions are applied to reduce the shareholder's basis in any indebtedness owed by the S corporation to the shareholder.[2] § 1367(b)(2)(A).

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[2] An S corporation shareholder typically would not be entitled to a deduction upon making a loan to an S corporation and would not include in income any repayment of the principal by the corporation to the extent it is less than or equal to the

(Continued on following page)

If the shareholder's basis in indebtedness was so reduced, any net increase in basis in a subsequent tax year, as determined pursuant to §§ 1367(a)(1)(A) and 1366(a)(1)(A), is first applied to restore the shareholder's basis in indebtedness before it is applied to restore the shareholder's basis in stock. § 1367(b)(2)(B).

The three S corporations in this case, Wishnatzki & Nathel, Inc. ("W & N New York"), G & D Farms, Inc. ("G & D Farms"), and Wishnatzki & Nathel of California, Inc. ("W & N California"), were organized to operate food distribution businesses in New York, Florida, and California. The Nathels each owned twenty-five percent of the corporations and Mr. Wishnatzki owned fifty percent.

In June 1999, the Nathels and Mr. Wishnatzki personally guaranteed $ 2.5 million in loans made by two banks to G & D Farms. In December 2000, Ira and Sheldon Nathel each made personal loans in the amount of $ 649,775 to G & D Farms. As of December 31, 2000, the Nathels each had a zero basis in their G & D Farms and W & N California stock. They each had a basis of $ 112,547 in loans they made to G & D

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shareholder's basis in the loan. *See Nat'l Bank of Commerce of Seattle v. Comm'r*, 115 F.2d 875, 876 (9th Cir. 1940) (finding that repayment of money lent is not income). The shareholder's basis in the loan would equal the amount of the original principal, subject to any subsequent adjustments to basis. *See* § 1012; § 1366(d)(1)(B).

Farms and a basis of $ 3,603 in loans made to W & N California.

In February 2001, G & D Farms repaid the Nathels' December 2000 personal loans in the full amount of $ 649,775 each. In August 2001, the Nathels and Mr. Wishnatzki agreed to a plan to liquidate W & N California and to convey full ownership of G & D Farms to Mr. Wishnatzki and full ownership of W & N New York to the Nathels. Prior to its liquidation, W & N California repaid outstanding loans to the Nathels in the amount of $ 161,250 each. The Nathels then made capital contributions to W & N California in the amount of $ 181,396 each. The Nathels also made capital contributions to G & D Farms in the amount of $ 537,228 each. In the parties' stipulation before the Tax Court, they indicated that the capital contributions to G & D Farms "were made by the Nathels to secure the release of their respective guarantees of [G & D Farms'] debts to the Banks and to obtain [Mr. Wishnatzki's] agreement to the release of the Nathels from their guarantees and to the reorganization plan." (Stipulation of Facts ("Stip.") P 34.) The parties also stipulated that "[a]s a condition for releasing Sheldon and Ira from their guarantees of [G & D Farms'] debt, the Banks and [Mr. Wishnatzki] required Sheldon and Ira to each contribute to [G & D Farms] additional capital in the amount of $ 537,228.00." (Stip. P 26.) In sum, in 2001, the Nathels received a combined $ 1,622,050 in loan repayments from the two corporations and made a combined total of $ 1,437,248 in capital contributions.

In calculating their 2001 taxes, the Nathels treated their capital contributions to G & D Farms and W & N California as constituting "tax-exempt income" to the corporations for the purposes of § 1366(a)(1)(A). Therefore, because the Nathels' bases in their stock previously had been reduced to zero and because their bases in the loans they made to the corporations were also reduced, the Nathels used their capital contributions to restore their bases in the loans pursuant to § 1367(b)(2)(B). Without such an increase in their bases, the petitioners would have been taxed on the ordinary income that would have resulted from the corporations' repayment of the petitioners' loans in amounts above the petitioners' previously reduced bases.

The Commissioner rejected the Nathels' treatment of the capital contributions. The Commissioner determined that the Nathels' capital contributions could not be used to offset the ordinary income that resulted from the amount of the corporations' repayment of the Nathels' loans above the Nathels' then-existing bases in the loans. Instead, the Commissioner determined that the capital contributions increased the petitioners' bases in their G & D Farms and W & N California stock. Because the petitioners redeemed their stock as part of the reorganization plan, the Commissioner determined that they were entitled to a long-term capital loss in light of their now-increased bases in the stock. The net effect of the Commissioner's calculation was an increase in the tax owed by the Nathels in 2001.

The Commissioner mailed a notice of deficiency dated June 21, 2006, to Ira and Tracy Nathel, indicating that they owed an additional $ 279,847 in income taxes for 2001. The Commissioner also mailed a notice of deficiency dated June 21, 2006, to Sheldon and Ann M. Nathel, indicating that they owed an additional $ 279,722. Both couples filed a timely petition in the Tax Court for a redetermination of the deficiencies. The Tax Court granted the parties' joint motion to consolidate the cases. In an opinion dated December 17, 2008, the Tax Court rejected the petitioners' challenges to the deficiencies determined by the Commissioner.[3] *Nathel v. Comm'r*, 131 T.C. 262 (2008).

DISCUSSION

I

We accept the stipulated facts the parties submitted to the Tax Court. We review the Tax Court's legal conclusions *de novo*. *Reimels v. Comm'r*, 436 F.3d 344, 346 (2d Cir. 2006).

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[3] In addition to the arguments raised on appeal, the petitioners argued in the Tax Court that their capital contributions were deductible as ordinary losses incurred in a trade or business pursuant to § 165(c)(1). The Tax Court rejected that argument and the petitioners have abandoned it on appeal.

II

The petitioners' argument that their capital contributions can be used to increase the bases of their loans to the corporations begins with the Code. Section 1367(b)(2)(B) allows taxpayers to restore any basis in indebtedness that was reduced in a prior tax year if there is any "net increase" in basis in a subsequent tax year pursuant to § 1367(a)(1)(A). Section 1367(a)(1)(A), in turn, provides that a shareholder's basis is increased by a corporation's receipt of "the items of income described in" § 1366(a)(1)(A). Section 1366(a)(1)(A) provides that a shareholder's pro rata share of a corporation's "items of income (including tax-exempt income)," among other things, should be taken into account in calculating an S corporation shareholder's tax.

The petitioners make the novel argument that capital contributions constitute "items of income (including tax-exempt income)" for the purposes of § 1366(a)(1)(A). They make this argument despite 26 U.S.C. § 118(a), which provides that "[i]n the case of a corporation, gross income does not include any contribution to the capital of the taxpayer." They argue that capital contributions are income, although tax-exempt income.

We are aware of no case that has decided whether capital contributions constitute "items of income (including tax-exempt income)" for the purposes of § 1366(a)(1)(A). However, while the question whether "income" in § 1366(a)(1)(A) includes capital

contributions has not been resolved, courts frequently have addressed the scope of "income" as used in 26 U.S.C. § 61(a) and in the Sixteenth Amendment.[4] Those cases indicate that capital contributions traditionally are not considered to be "income" and, therefore, should not be considered "items of income" under § 1366(a)(1)(A).

In determining whether capital contributions constitute "items of income (including tax-exempt income)," we look first to the traditional distinction between income and capital. In *Eisner v. Macomber*, 252 U.S. 189, 219, 40 S. Ct. 189, 64 L. Ed. 521, 1920-3

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[4] Section 61(a) of the Code states: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived. . . ."

The *Sixteenth Amendment* allows Congress to "lay and collect Taxes on incomes, from whatever source derived, without apportionment among the several States." *See also* U.S. Const. art. I, § 2, cl. 3 ("[D]irect Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers. . . ."); U.S. Const. art. I, § 9, cl. 4 ("No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.").

It should be noted that "gross income" in § 61(a) is at least as broad as the meaning of "incomes" in the *Sixteenth Amendment*. *See Murphy v. IRS*, 493 F.3d 170, 176, 178-79, 377 U.S. App. D.C. 197 (D.C. Cir. 2007). The petitioners have not suggested that the definition of "income" for purposes of § 1366(a)(1)(A) should be broader than the meaning of "incomes" under the Sixteenth Amendment, and we therefore find cases interpreting both "income" under § 61(a) and "incomes" under the Sixteenth Amendment to be instructive.

C.B. 25, T.D. 3010 (1920), the Supreme Court determined that a shareholder's receipt of a stock distribution was not income to the shareholder and, therefore, Congress's attempt to tax the stock dividend was not authorized by the Sixteenth Amendment. Rejecting the argument that the shareholder could be taxed on the corporation's underlying accumulated profits,[5] the Court stated that "enrichment through increase in value of capital investment is not income in any proper meaning of the term." *Id.* at 214-15. The Court drew a clear distinction between income and capital, defining income as "the gain derived from capital, from labor, or from both combined." *Id.* at 207 (internal quotation marks omitted).

Consistent with this definition, in *Edwards v. Cuba Railroad Co.*, 268 U.S. 628, 632-33, 45 S. Ct. 614, 69 L. Ed. 1124, 1925-2 C.B. 122, T.D. 3728 (1925), the Supreme Court found that subsidy payments from the Cuban government to the defendant railroad company were reimbursements for "capital expenditures" and were not profits or gains to the corporation, and, therefore, were not income for purposes of the Sixteenth Amendment. An early case by this Court similarly distinguished income from

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[5] The Court noted that a shareholder's share of a corporation's accumulated profits could be taxed, but such taxation would be the taxation of property because of ownership, not income, and would require apportionment under Article I, section 2, clause 3 and Article I, section 9, clause 4 of the Constitution. *Macomber*, 252 U.S. at 217; *see also* n. 4, *supra*.

capital. In *United States v. Oregon-Washington Railroad & Navigation Co.*, 251 F. 211, 213 (2d Cir. 1918), Judge Learned Hand noted that the Code's use of "income" "unquestionably imports . . . the current distinction between what is commonly treated as the increase or increment from the exercise of some economically productive power . . . and the power itself."[6] Judge Hand stated that "income" "should not include such wealth as is honestly appropriated to what would customarily be regarded as the capital of the corporation taxed." *Id.*

Macomber's limited definition of income was expanded in *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3, 52 S. Ct. 4, 76 L. Ed. 131, 72 Ct. Cl. 739 (1931) (finding that discharge of indebtedness caused the corporation taxpayer to realize an "accession to income" and was taxable under the Code). Subsequently, in *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431, 75 S. Ct. 473, 99 L. Ed. 483, 1955-1 C.B. 207 (1955), the Supreme Court adopted a broad definition of income as "instances of undeniable

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[6] *Oregon-Washington's* holding, that discharge of indebtedness that was "a means of contribution to [the corporation's] capital account" did not constitute taxable income to the corporation, *Oregon-Washington*, 251 F. at 213, was later abrogated by 26 U.S.C. § 108(e)(6), which provides a mechanism for taxing discharge of indebtedness that was acquired by a corporation from a shareholder as a capital contribution. We address the petitioners' argument that § 108(e)(6) demonstrates that capital contributions constitute "items of income" for the purposes of § 1366(a)(1)(A) below.

accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." In *Glenshaw Glass*, the Supreme Court held that a punitive damages award was taxable because it was included in the definition of "gross income" under the Code. *Id.* at 432-33. The Court found that through its then-existing definition of gross income as "income derived from any source whatever," Congress intended "to exert in this field 'the full measure of its taxing power'" and thus to tax "all gains except those specifically exempted" by the Code. *Id.* at 429-30 (quoting *Helvering v. Clifford*, 309 U.S. 331, 334, 60 S. Ct. 554, 84 L. Ed. 788, 1940-1 C.B. 105 (1940)); *see also Collins v. Comm'r*, 3 F.3d 625, 630 (2d Cir. 1993). The Court distinguished the narrow definition of income in *Macomber*, but in doing so, it was careful to maintain the distinction between capital and income:

> Nor can we accept respondents' contention that a narrower reading of [the predecessor of § 61(a)] is required by the Court's characterization of income in [*Macomber*], as "the gain derived from capital, from labor, or from both combined." The Court was there endeavoring to determine whether the distribution of a corporate stock dividend constituted a realized gain to the shareholder, or changed 'only the form, not the essence,' of his capital investment. It was held that the taxpayer had 'received nothing out of the company's assets for his separate use and benefit.' The distribution, therefore, was held not a taxable event. *In that context – distinguishing gain from capital – the definition*

> *served a useful purpose*. But it was not meant to provide a touchstone to all future gross income questions.

Glenshaw Glass, 348 U.S. at 430-31 (emphasis added) (citations omitted).

Congress has specifically recognized that capital contributions are not income. In 1954, Congress enacted § 118(a) of the Code, which provides that, "[i]n the case of a corporation, gross income does not include any contribution to the capital of the taxpayer." Internal Revenue Code of 1954, Pub. L. No. 83-591, ch. 736, § 118(a), 68A Stat. 3, 39. The legislative history of § 118(a) indicates that the purpose of that section was to codify pre-1954 court decisions holding that certain payments to corporations by non-shareholders should be treated as capital contributions and not as income to the corporations, just as shareholder contributions were not treated as income to the corporations. *See* H.R. Rep. No. 83-1337, at 17 (1954), *reprinted* in 1954 U.S.C.C.A.N. 4017, 4042 (noting that § 118(a) "in effect places in the [C]ode the court decisions" on the subject of contributions from "individuals having no proprietary interest in the corporation"); S. Rep. No. 83-1622, at 18 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4648 (same). While not explicitly listed, the legislative history most likely referred to several Supreme Court cases delineating the boundaries of capital contributions as distinguished from taxable income. *Compare Brown Shoe Co. v. Comm'r*, 339 U.S. 583, 591, 70 S. Ct. 820, 94 L. Ed. 1081, 1950-1 C.B. 38 (1950) (holding that

payments to entice the location of a corporation's factories in certain communities were nontaxable capital contributions), *with Detroit Edison Co. v. Comm'r*, 319 U.S. 98, 102-03, 63 S. Ct. 902, 87 L. Ed. 1286, 1943 C.B. 1019 (1943) (holding that payments from an electric company's customers were not contributions to capital) *and Texas & Pac. Ry. Co. v. United States*, 286 U.S. 285, 289-90, 52 S. Ct. 528, 76 L. Ed. 1108, 74 Ct. Cl. 746, 1932 C.B. 263, 1932-1 C.B. 263 (1932) (finding that government subsidies to guarantee a railroad a minimum revenue were not contributions to capital).

In 1960, the Internal Revenue Service ("I.R.S.") promulgated Treasury Regulation section 1.118-1, which notes that § 118(a) applies to capital contributions from both shareholders and nonshareholders. The Regulation provides that "voluntary pro rata payments" to a corporation from its shareholders for the purposes of providing "additional funds for conducting [the corporation's] business . . . do not constitute income" to the corporation. *Treas. Reg.* § 1.118-1. This Regulation is entitled to deference by this Court and is fatal to the petitioners' position. *See McNamee v. Dep't of Treasury*, 488 F.3d 100, 106 (2d Cir. 2007) ("Because Congress has delegated to the Commissioner the power to promulgate all needful rules and regulations for the enforcement of [the Code], we must defer to his regulatory interpretations of the Code so long as they are reasonable." (internal quotation marks and citation omitted)); *United States v. Mazza-Alaluf*, 607 F. Supp. 2d 484, 496 (S.D.N.Y.

2009) ("*Chevron* deference is warranted for Treasury regulations passed under the authority delegated to it by Congress.").

The petitioners' argument that capital contributions constitute "tax-exempt income," despite the traditional treatment of capital contributions as distinct from income, is centered on the relatively recent *Gitlitz* case. In *Gitlitz*, the petitioners were shareholders of an insolvent S corporation that realized a discharge of indebtedness. 531 U.S. at 210. The S corporation excluded the discharge of indebtedness amount from taxable income pursuant to 26 U.S.C. § 108(a)(1)(B) and (d)(7)(A), which excludes discharge of indebtedness from gross income if the taxpayer is insolvent. *Id.* The petitioners then increased their bases in the corporation's stock by their pro rata share of the discharge of indebtedness under the theory that it was an "item of income [including tax-exempt income]," to the corporation pursuant to § 1366(a)(1)(A). *Id.* The Commissioner contended that the Code's exclusion of discharge of indebtedness from the gross income of insolvent taxpayers meant that the discharge of indebtedness at issue was no longer an "item of income" for the purposes of § 1366(a)(1)(A) and could not be used to increase the petitioners' bases. *Id.* at 213.

The Supreme Court upheld the taxpayers' treatment of the discharge of indebtedness, holding that § 108(a)'s exclusion of certain discharge of indebtedness income from gross income does not change its fundamental character as an "item of

income."[7] *Id.* at 214. The Court noted that § 61(a)(12) explicitly provides that discharge of indebtedness generally is included in gross income. *Id.* at 213. The Court reasoned that while §§ 101 through 136 exclude certain items from gross income, the "mere exclusion of an amount from gross income does not imply that the amount ceases to be an item of income." *Id.* The Court also stated that "[i]f discharge of indebtedness of insolvent entities were not actually 'income,' there would be no need to provide an exception to its inclusion in gross income." *Id.* at 214.

The petitioners argue that, based on the reasoning in *Gitlitz*, there would be no need to exclude capital contributions from gross income, as § 118(a) does, if capital contributions were not already included in gross income pursuant to § 61(a). The petitioners argue that, therefore, capital contributions

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[7] The Supreme Court acknowledged that the result of *Gitlitz* would be to allow shareholders a "double windfall": The corporation's discharge of indebtedness income would be excluded and not passed through as taxable income and the shareholders would be able to increase their bases in stock. *Gitlitz*, 531 U.S. at 219-20. However, the Court found that the result was required by the "plain text" of the Code. *Id.* at 220. After *Gitlitz* was decided, Congress added language to § 108(d)(7)(A) barring the pass-through of excluded discharge of indebtedness income to the shareholders of S corporations and eliminating the resulting increase in basis: "In the case of an S corporation, subsections (a), (b), (c), and (g) shall be applied at the corporate level, including by not taking into account under section 1366(a) any amount excluded under subsection (a) of this section." Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 402(a), 116 Stat. 21, 40.

are fundamentally income and constitute "items of income (including tax-exempt income)" for the purposes of § 1366(a)(1)(A). This argument ignores the critical difference between *Gitlitz* and this case: *Gitlitz* addressed payments that explicitly were included in gross income under § 61(a). *See* § 61(a)(12) ("[G]ross income means all income . . . including (but not limited to) . . . (12) [i]ncome from discharge of indebtedness. . . ."). While the petitioners are correct that the list of items of income in § 61(a) is not exclusive, the petitioners cannot rely on *Gitlitz* alone to overcome the long-standing treatment of capital contributions as distinct from income. *Gitlitz* did not create any new items of income. *Gitlitz* only held that the nature of discharge of indebtedness as income was not changed by the exclusion in § 108(a).

Unlike this case, the Commissioner in *Gitlitz* admitted that the item at issue – discharge of indebtedness – generally was included in gross income, but argued that the exclusion of discharge of indebtedness of insolvent entities in § 108(a) altered the character of that item. It was only in rejecting this argument that *Gitlitz* noted that it would be unnecessary to exclude discharge of indebtedness of insolvent entities from gross income if discharge of indebtedness in general were not already income. In this case, capital contributions traditionally have not been included in gross income in the first instance and the fact that § 118(a) explicitly excludes them does not transform them into "items of income" for the purposes of § 1366(a)(1)(A).

The petitioners' view of the superfluous nature of § 118(a) is belied by the legislative history of that section. The legislative history of § 118(a) shows that, unlike discharge of indebtedness, Congress did not consider shareholder capital contributions to be generally includible in gross income when it created the exclusion. *See State Farm Road Corp. v. Comm'r*, 65 T.C. 217, 227 (1975) (noting that § 118 was "intended as an incorporation of existing decisional law"). As discussed above, § 118(a)'s exclusion of "*any* contribution to the capital of the taxpayer" (emphasis added) was intended to codify certain cases finding that nonshareholder, in addition to shareholder, capital contributions were not income. Treasury Regulation section 1.118-1 underscores this understanding of § 118(a) by explicitly stating that both shareholder and nonshareholder capital contributions "do not constitute income" to a corporation.

In addition to their argument based on *Gitlitz* and § 118, the petitioners argue that § 108(e)(6) demonstrates that capital contributions constitute income. Section 108(e)(6) provides a mechanism for taxing the discharge of any indebtedness that was acquired by a corporation as a capital contribution. Section 108(e)(6) provides that

> for purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital –

> (A) section 118 shall not apply, but
>
> (B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

The petitioners argue that because § 108(e)(6) allows for discharge of indebtedness acquired as a capital contribution to be taxed as income to the corporation, capital contributions must be "items of income" for the purposes of § 1366(a)(1)(A). However, discharge of indebtedness is explicitly included in gross income in § 61(a)(12) and, under *Gitlitz*, is an "item of income" for the purposes of § 1366(a)(1)(A) even when it is exempt from taxation. The fact that Congress chose, when confronted with the confluence of discharge of indebtedness, which is income, and capital contributions, which traditionally have not been considered income, to subject discharge of indebtedness acquired as a capital contribution to taxation does not mean that capital contributions that are not discharge of indebtedness constitute "items of income (including tax-exempt income)" for the purposes of § 1366(a)(1)(A).[8]

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[8] The legislative history of § 108(e)(6) indicates that it was enacted to override the decision of the Court of Appeals for the Fifth Circuit in *Putoma Corp. v. Commissioner*, 601 F.2d 734, 751 (5th Cir. 1979), which held that a shareholder's discharge of indebtedness acquired by the corporation as a capital contribution was not taxable income to the corporation because it was a

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We are not aware of any case that has held that capital contributions are "income" under § 1366(a)(1)(A) or any other provision of the Code. On the contrary, the Supreme Court and this Court have repeatedly emphasized the distinction between capital and income. *See, e.g., Macomber*, 252 U.S. at 214-15; *Cuba R.R.*, 268 U.S. at 632-33; *Oregon-Washington*, 251 F. at 213. The petitioners argue that *Glenshaw Glass* has overruled the earlier cases' treatment of capital as distinct from income because it rejected *Macomber's* definition of income as "'the gain derived from capital, from labor, or from both combined.'" *Glenshaw Glass*, 348 U.S. at 430-31 (quoting *Macomber*, 252 U.S. at 207). However, the decision in *Glenshaw Glass* was founded on "the intention of Congress to tax all gains except those specifically exempted." *Glenshaw Glass*, 348 U.S. at 430. In deciding that the punitive damages at issue in that case were a taxable gain, even though not derived from capital or labor, *Glenshaw Glass* did not overrule the previous cases' distinction between capital and income. On the contrary, *Glenshaw Glass* recognized that *Macomber's* definition of income was "useful" in that case precisely because it "distinguish[ed] gain from capital." *Id.* at 431. Capital contributions are not gains to a corporation. Rather, they "represent an additional price paid for[ ] the shares of stock held by the individual shareholders" of a corporation, and are treated

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capital contribution. S. Rep. No. 96-1035, at 18-19, 56 n.24 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7033-34, 7068 n.24.

as a part of the operating capital of the company. Treas. Reg. § 1.118-1.

In arguing that *Glenshaw Glass* erased the traditional distinction between capital contributions and income, the petitioners also rely on an I.R.S. General Counsel Memorandum dated December 21, 1977 (the "Memorandum"), which addressed whether certain nonshareholder contributions made to a public utility constituted excludable capital contributions under § 118(a) or constituted taxable income to the utility. The Memorandum concluded that because the contributions were motivated by the nonshareholder's desire to obtain a more reliable source of electric power, the amounts were taxable income, not contributions to capital. In providing a history of the taxation of nonshareholder capital contributions, the Memorandum noted that "the constitutional basis" of *Cuba Railroad* "seems to have been considerably weakened" by *Glenshaw Glass* and its progeny. I.R.S. Gen. Couns. Mem. 37,354 (Dec. 21, 1977) (citing *State Farm Road Corp.*, 65 T.C. at 227). The Memorandum explained that payments like those made by the Cuban government to the railroad "can no longer be characterized as falling outside the scope of gross income within the meaning of Code § 61." I.R.S. Gen. Couns. Mem. 37,354 (Dec. 21, 1977). Rather, according to the Memorandum, those payments would be part of a "new class of tax-exempt transactions, called contributions to capital, that was codified in 1954 as Code § 118." *Id.*

I.R.S. General Counsel Memoranda are informal documents written by the I.R.S. Chief Counsel's office. They provide the Chief Counsel's opinion on particular tax matters before other I.R.S. officials. The Memorandum at issue in this case includes a disclaimer that it is "not to be relied upon or otherwise cited as precedent by taxpayers." *Id.* As a result, the Memorandum is not entitled to deference under *Chevron U.S.A. Inc. v. National Resources Defense Council, Inc.*, 467 U.S. 837, 104 S. Ct. 2778, 81 L. Ed. 2d 694 (1984), because it is an informal letter that itself renounces any force-of-law effect.[9] *See United States v. Mead Corp.*, 533 U.S. 218, 226-27, 121 S. Ct. 2164, 150 L. Ed. 2d 292 (2001) (holding that *Chevron* deference is appropriate "when it appears that Congress delegated authority to the

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[9] In *Morganbesser v. United States*, 984 F.2d 560, 563 (2d Cir. 1993) (quoting *Herrmann v. E.W. Wylie Corp.*, 766 F. Supp. 800, 802-03 (D.N.D. 1991)), this Court noted that "[General Counsel Memoranda] are helpful in interpreting the Tax Code when 'faced with an almost total absence of case law.'" The Court, therefore, found it "arguably permissible" to use General Counsel Memoranda ("GCMs") to "*instruct* the court on how the [I.R.S.] itself" defines "labor organization," because they were "the only real guidance as to what the [I.R.S.] considers a labor organization for the purposes" of the Code. *Id.* Courts of Appeals in other circuits have declined to rely on GCMs. *See Tupper v. United States*, 134 F.3d 444, 448 & n.5 (1st Cir. 1998) ("GCMs . . . are not authority in this court."); *Stichting Pensioenfonds Voor de Gezondheid v. United States*, 129 F.3d 195, 200 (D.C. Cir. 1997) ("These 'GCMs,' however, have no precedential value."); *Disabled Am. Veterans v. Comm'r*, 942 F.2d 309, 315 n.5 (6th Cir. 1991) ("Such informal, unpublished opinions of attorneys within the [I.R.S.] are of no precedential value. . . .").

agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority"); *Christensen v. Harris County*, 529 U.S. 576, 587-88, 120 S. Ct. 1655, 146 L. Ed. 2d 621 (2000) (holding that agency interpretations contained in informal opinion letters are not entitled to *Chevron* deference). Any "respect" afforded to the Memorandum would only be proportional to its "power to persuade" pursuant to *Skidmore v. Swift & Co.*, 323 U.S. 134, 140, 65 S. Ct. 161, 89 L. Ed. 124 (1944). *Christensen*, 529 U.S. at 587.

In this case, we decline to rely on the Memorandum because it disclaims precedential effect and is not entitled to deference under *Chevron*. Furthermore, the persuasiveness of the Memorandum is limited in light of the fact that the Memorandum does not address the question whether capital contributions such as those in this case constitute "tax-exempt income" for the purposes of § 1366(a)(1)(A). The Memorandum, like *Cuba Railroad*, deals only with nonshareholder capital contributions, the scope of which has been clarified by several Supreme Court decisions following *Cuba Railroad*. *See, e.g., Brown Shoe Co.*, 339 U.S. at 591-93; *Detroit Edison Co.*, 319 U.S. at 103.

Finally, the petitioners point to two cases from Courts of Appeals in other circuits that allegedly show that capital contributions constitute income. In one case, the Court of Appeals for the Seventh Circuit referred to "tax-exempt capital contributions." *Am.*

Med. Ass'n v. United States, 887 F.2d 760, 774 (7th Cir. 1989). In the other, the Court of Appeals for the Ninth Circuit addressed whether certain payments were "exempt from federal income tax as contributions to capital." *Washington Athletic Club v. United States*, 614 F.2d 670, 671 (9th Cir. 1980). The petitioners argue that because the above cases referred to capital contributions as being "exempt" from income, these cases demonstrate that capital contributions are "tax-exempt income" for the purposes of § 1366(a)(1)(A). However, these cases did not hold that capital contributions constitute income. Rather, they discussed, among other things, whether certain membership fees paid to associations constituted capital contributions or taxable income. The fact that these cases may have used imprecise language to express the fact that capital contributions are not subject to taxation does not mean that capital contributions are income.[10] In fact, *American Medical Association* explicitly recognized the distinction between capital contributions and income when it noted that if the plaintiff in that case argued that certain funds it received "should be likened to capital contributions, it would argue that those monies should *never* be considered income." *Am. Med. Ass'n*, 887 F.2d at 774 n.15.

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[10] It is difficult to place too much emphasis on the specific language in those decisions. In calculating taxable income, in most circumstances, there is no difference between the case where an item is included in gross income pursuant to § 61(a) and then excluded from gross income by another Code section and the case where the item is not includible under § 61(a) at all.

Therefore, for all of these reasons, we find that the petitioners' capital contributions do not constitute "items of income (including tax-exempt income)" under § 1366(a)(1)(A) and cannot be used to restore their bases in indebtedness pursuant to § 1367(b)(2)(B).

III

As an alternative to using their capital contributions to increase their loan bases and thereby reduce their taxable income, the petitioners argue that they should be allowed to deduct their capital contributions to G & D Farms as losses incurred in a transaction entered into for profit pursuant to § 165(c)(2). The petitioners do not argue that their capital contributions to W & N California should be deductible.

Section 165(c)(2) provides that individuals are allowed a deduction from taxable income for "losses incurred in any transaction entered into for profit, though not connected with a trade or business." In general, a negotiated payment to secure a release from conditional liability under a loan guarantee is deductible as a loss incurred in a transaction entered into for profit. *See, e.g., Duke v. United States*, No. 75 Civ. 5122, 1977 U.S. Dist. LEXIS 17603, 1977 WL 1082, at *2 (S.D.N.Y. Jan. 31, 1977); *Shea v. Comm'r*, 36 T.C. 577, 582 (1961), *aff'd*, 327 F.2d 1002 (5th Cir. 1964); *Lloyd-Smith v. Comm'r*, 40 B.T.A. 214, 223 (1939), *aff'd on other grounds*, 116 F.2d 642 (2d Cir. 1941).

"This court has repeatedly held that, in determining the deductibility of a loss, the primary motive must be ascertained and given effect." *Austin v. Comm'r*, 298 F.2d 583, 584 (2d Cir. 1962); *see also Helvering v. Nat'l Grocery Co.*, 304 U.S. 282, 289 n.5, 58 S. Ct. 932, 82 L. Ed. 1346, 1938-1 C.B. 279 (1938) ("[T]he deductibility of losses under [the predecessor of § 165(c)] may depend upon whether the taxpayer's motive in entering into the transaction was primarily profit."); *Ewing v. Comm'r*, 213 F.2d 438, 439 (2d Cir. 1954). The burden of proving the requisite motive is on the petitioners. *Cf. Sutton v. Comm'r*, 84 T.C. 210, 221 (1985), *aff'd*, 788 F.2d 695 (11th Cir. 1986).

Instead of looking to the "primary motive," some courts have attempted to ascertain whether the "sole purpose" of a taxpayer's payment was to secure a release from a loan guarantee before allowing the taxpayer to take a deduction pursuant to § 165(c)(2). *See Duke*, 1977 U.S. Dist. LEXIS 17603, 1977 WL 1082, at *2; *Shea*, 36 T.C. at 582; *Lloyd-Smith*, 40 B.T.A. at 223. In *Duke*, the court denied the taxpayers' motion for summary judgment because it could not determine if their payment was for the "sole purpose" of securing a release from a guarantee or rather was the purchase price of a capital asset. *Duke*, 1977 U.S. Dist. LEXIS 17603, 1977 WL 1082, at *2.

In this case, the Tax Court found that the petitioners "clearly had multiple purposes in making the[ir] capital contributions," and, therefore, distinguished this case from those that allowed deductions

upon finding that payments were made for the "sole purpose" of obtaining releases from loan guarantees. *Nathel*, 131 T.C. at 274. The Tax Court noted that the parties stipulated that the Nathels made the contributions in connection with the banks' release of the petitioners' guarantees, in connection with Mr. Wishnatzki's assumption of responsibility as a guarantor, and to obtain Mr. Wishnatzki's agreement to the reorganization plan. *Id.* The Tax Court found that, therefore, the petitioners did not make the contributions for the "sole purpose of being released from their guarantees on the bank loans" and, as a result, it found that the contributions were not deductible pursuant to § 165(c)(2). *Id.* at 274-75.

To the extent the Tax Court required the capital contributions to be for the sole purpose of obtaining releases from the loan guarantees, the Tax Court required too much. The capital contributions need only have been made for the primary purpose of obtaining the releases in order to be deductible as losses incurred in a transaction entered into for profit. However, the Tax Court's error was harmless because the petitioners did not meet their burden of showing that the primary purpose of the contributions was to obtain the releases from the guarantees.

The petitioners argue that the parties' stipulation before the Tax Court proves that the capital contributions were made for the primary purpose of obtaining the releases. The petitioners point to paragraph 26 of the stipulation, which provides that "[a]s a

condition for releasing [the Nathels] from their guarantees of [G & D Farms'] debt, the Banks and [Mr. Wishnatzki] required [the Nathels] to each contribute to [G & D Farms] additional capital in the amount of $ 537,228.00." (Stip. P 26.) The petitioners also rely on paragraph 34 of the stipulation, which provides that the Nathels' capital contributions to G & D Farms "were made . . . to secure the release of their respective guarantees of [G & D Farms'] debts to the Banks *and* to obtain [Mr. Wishnatzki's] agreement to the release of the Nathels from their guarantees *and* to the reorganization plan." (Stip. P 34 (emphasis added).)

While paragraph 26 of the stipulation states that the capital contributions were a condition of the petitioners' release from their loan guarantees, there is no stipulation that the primary purpose of the contributions was to obtain that release. Paragraph 34 of the stipulation provides that the capital contributions were made for three purposes: (1) to secure the petitioners' release from the guarantees of G & D Farms' debts, (2) to obtain Mr. Wishnatzki's agreement to the release of the Nathels from the guarantees, and (3) to obtain Mr. Wishnatzki's agreement to the reorganization plan. The stipulation, therefore, suggests that the capital contributions were made to achieve multiple purposes, without indicating which, if any, was the primary purpose.

The petitioners point to several cases that demonstrate that payments can have multiple purposes and still be deductible under § 165(c)(2). The

petitioners argue that these cases show that the capital contributions here are deductible. The petitioners read too much into these cases. In *Rushing v. Comm'r*, 58 T.C. 996, 1000-01, 1005 (1972), the Tax Court distinguished between two payments the taxpayers attempted to deduct: legal expenses connected with the petitioners' personal guarantee of a corporation's debt, which the court found to be deductible, and other fees related to the sale of the corporation's assets, which it found to be not deductible. *Rushing* simply demonstrates that if a court can determine that the principal purpose of any one of a number of payments was in connection with a transaction entered into for profit, then the payment may be deducted pursuant to § 165(c)(2). In this case, it cannot be determined what portion of petitioners' capital contributions, if any, was principally made to obtain the petitioners' release from the guarantees.

The petitioners also point to a case from another circuit, *Commissioner v. Condit*, 333 F.2d 585, 587-88 (10th Cir. 1964), in which the court found that the taxpayer "attained three objectives" through making a certain payment, including obtaining a release on a loan guarantee, settling a debt with the payee, and transferring the responsibility for winding up a business. The court found that the taxpayer's payment "was not the payment of a debt within the purview of [26 U.S.C.] § 166(d) but rather a loss incurred in a transaction for profit." *Id.* at 588. To the extent that the court in *Condit* found that the payment had no primary purpose, but nevertheless was deductible

pursuant to § 165(c)(2), it is inconsistent with prior decisions of this Court and we decline to follow it.

In addition to relying on the parties' stipulations regarding the purposes of the capital contributions, the petitioners argue that the fact that G & D Farms and W & N New York "were sold for each corporation's fair market value" to Mr. Wishnatzki and the Nathels, respectively (Stip. P 46), illustrates that the petitioners' capital contributions to G & D Farms could not have been part of the price the Nathels paid to obtain Mr. Wishnatzki's agreement to the sale of the companies. The petitioners argue that, therefore, the primary purpose of the capital contributions was to obtain the petitioners' release from the loan guarantees. However, there is no reason to believe that the petitioners' capital contributions were not part of the "fair market value" price for which the corporations were sold as part of the reorganization plan.

In their reply brief, the petitioners argue for the first time that their capital contributions were made in connection with a transaction entered into for profit because, as shareholders of both G & D Farms and W & N New York at the time, they signed their personal guarantees of G & D Farms' loans in order to improve the financial position of both corporations, in light of the fact that W & N New York's business allegedly was dependent on receiving produce from G & D Farms. However, the Commissioner does not contest that the Nathels' personal guarantees of G & D Farms' loans constituted a transaction entered into for profit. The question is whether the primary

purpose of the Nathels' subsequent capital contributions was to obtain releases from the loan guarantees. The fact that the Nathels expected the guarantees to benefit G & D Farms and W & N New York does not establish the primary purpose of the Nathels' capital contributions.

The petitioners did not meet their burden of showing that the capital contributions were primarily motivated by a desire to obtain releases from the loan guarantees. Therefore, the capital contributions are not deductible as losses incurred in a transaction entered into for profit pursuant to § 165(c)(2).

CONCLUSION

For all of the reasons explained above, we **AFFIRM** the Tax Court's decision.

IRA NATHEL AND TRACY NATHEL,
Petitioners
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent
SHELDON NATHEL AND ANN M. NATHEL,
Petitioners
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

Nos. 17203-06, 17204-06

UNITED STATES TAX COURT

131 T.C. 262; 2008 U.S. Tax Ct. LEXIS 37; 131 T.C. No. 17

December 17, 2008, Decided

COUNSEL: Hugh Janow, for petitioners.

Donald A. Glasel, for respondent.

JUDGES: Swift, Stephen J.

OPINION BY: STEPHEN J. SWIFT

OPINION

SWIFT, *Judge*: Respondent determined deficiencies in the respective amounts of $ 279,847 and $ 279,722 in petitioners Ira and Tracy Nathel's and in petitioners Sheldon and Ann M. Nathel's 2001 joint Federal income taxes. These cases have been consolidated for purposes of briefing and opinion.

In calculating petitioners' ordinary income on receipt of $ 1,622,050 in loan payments that petitioners received from two S corporations, the underlying issues for decision are whether for purposes of section 1366(a)(1) petitioners' $ 1,437,248 in capital contributions to the S corporations may be treated by petitioners as income to the S corporations and therefore as restoring or increasing petitioners' tax bases in the loans they made to the S corporations or, alternatively if the answer to the above issue is in the negative, whether capital contributions of $ 1,074,456 petitioners made to one of the S corporations may be treated by petitioners as deductible ordinary losses under section 165(c)(1) or (2).

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for 2001, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Background

The facts of these cases were submitted fully stipulated, and these cases are submitted under Rule 122.

At the time the petitions were filed, petitioners resided in New York.

Petitioners Ira and Sheldon Nathel (petitioners[1]) are brothers. Before 1999 petitioners and an individual named Gary Wishnatzki (Gary) organized three S corporations to operate food distribution businesses in New York, California, and Florida. The corporations were named G&D Farms, Inc. (G&D), Wishnatzki & Nathel, Inc. (W&N), and Wishnatzki & Nathel of California, Inc. (W&N CAL).

Petitioners and Gary made capital contributions to each of the S corporations, and each petitioner owned 25 percent and Gary owned 50 percent of the shares of stock in each of the S corporations. In addition, petitioners each made loans to G&D and to W&N CAL on open account.[2]

During 1999, 2000, and 2001 petitioners were employed as officers of W&N and petitioners received from W&N substantial compensation. Petitioners were not employed by either G&D or by W&N CAL, and petitioners received no salary or wages from G&D or W&N CAL.

Petitioners were not in the trade or business of providing guaranties on loans.

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[1] Petitioners Tracy and Ann Nathel are named petitioners solely because they filed joint Federal income tax returns with their husbands. References to petitioners are to Ira and Sheldon Nathel.

[2] The record does not reflect whether petitioners made loans to W&N.

In June 1999 G&D borrowed approximately $ 2.5 million from two banks (bank loans). As collateral on the bank loans, petitioners and Gary each personally guaranteed the bank loans. Petitioners did not receive any compensation for guaranteeing the bank loans.

As a result of losses realized by G&D and W&N CAL in years prior to 2001 (which losses under section 1367(a)(2) reduced petitioners' tax bases in their stock in and in their loans to G&D and W&N CAL), as of January 1, 2001, petitioners' tax bases in their stock in and in their loans to G&D and W&N CAL were as follows:[3]

Petitioner	Jan. 1, 2001, Tax Bases In Stock In G&D	In Loans To W&N CAL	G&D	W&N CAL
Ira Nathel	$ 0	$ 0	$ 112,547	$ 3,603
Sheldon Nathel	0	0	112,547	3,603

On February 2, 2001, G&D made payments to each petitioner of $ 649,775 on the loans petitioners made to G&D.

In the spring and summer of 2001 disagreements arose between petitioners and Gary relating to the

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[3] No issue is raised herein as to petitioners' tax bases in their stock in W&N.

business plans for G&D, W&N, and W&N CAL, and petitioners and Gary decided to terminate their business association through a reorganization of G&D, W&N, and W&N CAL.

In implementing the reorganization, on August 30, 2001, petitioners and Gary entered into a number of essentially simultaneous transactions which resulted in Gary owning 100 percent of G&D, in petitioners owning 100 percent of W&N (each petitioner owning 50 percent), and in the liquidation of W&N CAL.

As part of the reorganization, on August 30, 2001, petitioners and Gary each made significant additional capital contributions to G&D and W&N CAL for the reasons and as described below.

In connection with the release of petitioners' guaranties on the bank loans, with Gary's assumption of the guaranties on the bank loans, and with Gary's agreement to the general plan of reorganization of G&D, W&N, and W&N CAL, each petitioner made additional capital contributions to G&D of $ 537,228.

In order to provide funds to W&N CAL so that W&N CAL could repay outstanding third-party loans of $ 725,586, each petitioner also made additional capital contributions to W&N CAL of $ 181,396 and Gary made additional capital contributions to W&N CAL of $ 362,794.

Following petitioners' and Gary's additional capital contributions, petitioners' stock in G&D and

Gary's stock in W&N were redeemed without petitioners' and Gary's receiving any payment therefor, petitioners' guaranties were released, and Gary was left as sole guarantor on the G&D bank loans.

Further, on August 30, 2001, W&N CAL made payments to each petitioner of $ 161,250 on the loans petitioners made to W&N CAL.[4] W&N CAL was then liquidated, and petitioners received nothing in the liquidation.

In summary, after the reorganization of G&D, W&N, and W&N CAL, Gary owned 100 percent of G&D, petitioners each owned 50 percent of W&N, petitioners' guaranties on the bank loans were released, Gary was left as the sole guarantor on the bank loans, and W&N CAL was liquidated.

In the books and records of G&D and W&N CAL, petitioners' total August 30, 2001, capital contributions of $ 1,437,248 to G&D and to W&N CAL were reflected as contributions to the capital of G&D and W&N CAL.

In calculating petitioners' ordinary gain realized on receipt from G&D and from W&N CAL of the $ 1,622,050 loan payments, petitioners' August 30, 2001, capital contributions to G&D and to W&N CAL were treated by petitioners as constituting income

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[4] The loan payments each petitioner received in 2001 of $ 649,775 from G&D and $ 161,250 from W&N CAL equal total loan payments to both petitioners of $ 1,622,050.

under section 1366(a)(1) to G&D and W&N CAL (albeit as excludable income under section 118) and therefore as restoring or increasing under section 1367(b)(2)(B) petitioners' respective tax bases in the outstanding loans each petitioner made to G&D and W&N CAL as follows:

	Each Petitioner's Tax Bases in Loans To G&D and W&N CAL	
Loans To	Increased From	To
G&D	$ 112,546	$ 649,775
W&N CAL	3,603	184,999

On petitioners' respective 2001 individual Federal income tax returns, petitioners used the above increased tax bases in their loans to G&D and W&N CAL to offset all ordinary[5] income that otherwise would have been reportable upon their receipt in 2001 of the $ 1,622,050 loan payments from G&D and W&N CAL.

On audit respondent determined that petitioners' August 30, 2001, $ 1,437,248 capital contributions to G&D and W&N CAL should be treated simply as capital contributions by petitioners to G&D and W&N CAL and as increasing petitioners' tax bases in their stock in G&D and W&N CAL and not as restoring or

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[5] Petitioners do not dispute that income petitioners received in 2001 in connection with the $ 1,622,050 loan payments from G&D and W&N CAL is ordinary income.

increasing under sections 1366(a)(1) and 1367(b)(2)(B) petitioners' tax bases in the loans petitioners made to G&D and W&N CAL. Accordingly, respondent adjusted or reduced petitioners' tax bases in the loans petitioners had made to G&D and W&N CAL as set forth below:

Loans To	Each Petitioner's Tax Bases Reduced To
G&D	$ 112,546
W&N	3,603

On the basis of respondent's reductions in petitioners' tax bases in the loans to G&D and W&N CAL, respondent determined that each petitioner was chargeable with $ 694,875 in ordinary income relating to the $ 1,622,050 loan payments petitioners received in 2001 from G&D and W&N CAL.[6]

Respondent's above determinations resulted in the deficiencies determined against petitioners for 2001.

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[6] Because respondent determined that petitioners' Aug. 30, 2001, $ 1,437,248 capital contributions to G&D and W&N CAL increased petitioners' tax bases in their stock in G&D and W&N CAL, respondent also determined that each petitioner realized a $ 718,624 long-term capital loss on the Aug. 30, 2001, redemption and liquidation of their stock in G&D and W&N CAL.

Discussion

Generally, a shareholder in an S corporation has a tax basis in his stock equal to the amount of the contributions he makes to the capital of the S corporation, and the shareholder's capital contributions are not included in the income of the S corporation. Secs. 118, 1016(a)(1), 1371(a); *Commissioner v. Fink*, 483 U.S. 89, 94, 107 S. Ct. 2729, 97 L. Ed. 2d 74 (1987); *Edwards v. Cuba R.R. Co.*, 268 U.S. 628, 633, 45 S. Ct. 614, 69 L. Ed. 1124, 1925-2 C.B. 122, T.D. 3728 (1925); *Ellinger v. United States*, 470 F.3d 1325, 1329 (11th Cir. 2006); *Maloof v. Comm'r*, 456 F.3d 645, 648 (6th Cir. 2006), *affg.* T.C. Memo. 2005-75; *Sleiman v. Commissioner*, 187 F.3d 1352, 1356 (11th Cir. 1999), *affg.* T.C. Memo. 1997-530; sec. 1.118-1, Income Tax Regs.

A shareholder in an S corporation also has a tax basis in loans the shareholder makes to the S corporation equal to the amount of the loans. Secs. 1012, 1366(d)(1)(B).

Generally, under section 1367 a shareholder's tax bases in the stock in, and in the loans to, an S corporation are adjusted to reflect the shareholder's share of income, losses, deductions, and credits of the S corporation as calculated under section 1366(a)(1).

More specifically, under section 1367(a)(1) a shareholder's tax basis in stock in an S corporation is increased by, among other things, the shareholder's

share of the S corporation's income items (including "tax-exempt income"[7]), and under section 1367(a)(2) a shareholder's tax basis in his stock in an S corporation is decreased (but not below zero) by, among other things, the shareholder's share of losses and deductions.

If a shareholder's tax basis in his stock in an S corporation is reduced to zero by his share of the losses of the S corporation, any further share of the S corporation's losses decreases, but not below zero, the shareholder's tax basis in outstanding loans the shareholder has made to the S corporation. Sec. 1367(b)(2)(A); sec. 1.1367-2(b)(1), Income Tax Regs. Thus, a shareholder's tax basis in loans the shareholder has made to an S corporation may be lower than their face amount or zero because of downward adjustments in such basis caused by losses of the S corporation that are passed through to the shareholder. Sec. 1367(b)(2)(A).

Any "net increase"[8] in a year in a shareholder's share of an S corporation's income is applied first to

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[7] Sec. 1.1366-1(a)(2)(viii), Income Tax Regs., defines "tax-exempt income" for purposes of sec. 1366(a)(1) as income which is permanently excluded from gross income. This regulation was effective Aug. 18, 1998. T.D. 8852, 2000-1 C.B. 253.

[8] "[N]et increase" is defined as the amount by which the shareholder's pro rata share of the items described in sec. 1367 (a)(1) (relating to income items) exceed the items described in sec. 1367(a)(2) (relating to losses and deductions) for the taxable year. Sec. 1.1367-2(c)(1), Income Tax Regs.

(Continued on following page)

restore or increase the shareholder's tax basis in loans the shareholder made to the S corporation (to the extent such loan basis was reduced in prior years) and is then applied to increase the shareholder's tax basis in his stock in the S corporation. Sec. 1367(b)(2)(B); sec. 1.1367-2(c)(1), Income Tax Regs.

The above section 1367(b)(2)(B) shareholder tax basis adjustments affect the amount of gain or loss realized by a shareholder on a subsequent sale, redemption, or liquidation of the shareholder's stock in the S corporation, as well as the amount of ordinary income realized by the shareholder on the S corporation's payments on loans to the shareholder. *See* secs. 302(b)(3), 1001(a), 1221; *Cornelius v. Commissioner*, 58 T.C. 417, 422 (1972), *affd.* 494 F.2d 465 (5th Cir. 1974).

Petitioners acknowledge that their August 30, 2001, $ 1,437,248 capital contributions were made by them to G&D and W&N CAL as capital contributions and that as such the capital contributions generally would be included in the tax bases of their stock in G&D and W&N CAL and would not be included in the income of G&D or W&N CAL.

Petitioners have not cited nor have we found any cases where a shareholder's capital contributions to

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/9/ Petitioners' alternative loss argument relates only to petitioners' $ 1,074,456 Aug. 30, 2001, capital contributions to G&D.

an S corporation are treated as income to the S corporation.

In support of the treatment, however, of their August 30, 2001, $ 1,437,248 capital contributions as "income" to G&D and W&N CAL, petitioners argue that because section 118 excludes capital contributions from the gross income of an S corporation in all circumstances, capital contributions to an S corporation are "permanently excludible" from the gross income of the S corporation and are thus "tax-exempt income" under section 1.1366-1(a)(2)(viii), Income Tax Regs., and that "tax-exempt income" is to be included as an item of income to the S corporation for purposes of section 1366(a)(1) and the resulting section 1367 tax basis adjustments.

In support of their argument petitioners rely on *Gitlitz v. Comm'r*, 531 U.S. 206, 216, 121 S. Ct. 701, 148 L. Ed. 2d 613 (2001), in which the Supreme Court held that income received by an insolvent S corporation from discharge of indebtedness, excluded from gross income under section 108(a), is to be treated as an item of income to the corporation for purposes of section 1366(a)(1). Petitioners argue that the *Gitlitz* holding should apply not only to discharge of indebtedness income, excludable from corporate income under section 108(a), but also to other items of income which are specifically excluded from gross income of an S corporation under sections 101 through 136, such as section 118.

Petitioners rely on the following language from the Supreme Court's opinion in *Gitlitz*:

> Section 108(a) * * * does not say that discharge of indebtedness ceases to be an *item of income* when the S corporation is insolvent. Instead * * * [section 108(a)] provides only that discharge of indebtedness ceases to be *included in gross income.* * * * Moreover, sections 101 through 136 employ the same construction [as section 108] to exclude various items from gross income: "Gross income does not include. . . . " * * *
>
> * * * If discharge of indebtedness of insolvent entities were not actually "income," there would be no need to provide an exception to its inclusion in gross income. * * * [*Id.* at 213-214.]

By attempting to treat petitioners' capital contributions to G&D and W&N CAL as income to G&D and W&N CAL, petitioners in effect seek to undermine three cardinal and longstanding principles of the tax law: First, that a shareholder's contributions to the capital of a corporation increase the basis of the shareholder's stock in the corporation; see *Commissioner v. Fink, supra* at 94; sec. 1.118-1, Income Tax Regs.; second, that equity (i.e., a shareholder's contribution to the capital of a corporation) and debt (i.e., a shareholder's loan to the corporation) are distinguishable and are treated differently by both the Code and the courts; *see Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980);

compare sec. 163(a) with sec. 301(c); and third, that contributions to the capital of a corporation do not constitute income to the corporation; sec. 118; *Commissioner v. Fink, supra* at 94; *Edwards v. Cuba R.R. Co., supra* at 633 (holding that a contribution to a corporation's capital is not income to the corporation under the Sixteenth Amendment); *Ellinger v. United States, supra* at 1329; *Sleiman v. Commissioner, supra* at 1356; sec. 1.118-1, Income Tax Regs.

We do not believe that the *Gitlitz* holding or the provisions of subchapter S, namely sections 1366(a)(1), 1367(a)(1)(A), and 1367(b)(2)(B), should be interpreted to override these three longstanding principles of tax law.

The *Gitlitz* holding as to the treatment of discharge of indebtedness income as income to the S corporation under section 1366(a)(1) is distinguishable from the treatment of capital contributions made by a shareholder of an S corporation under section 118. In particular, under section 61(a)(12) discharge of indebtedness income is specifically included in the definition of "gross income". Unlike income from discharge of indebtedness, contributions to the capital of an S corporation are not listed in section 61 as an item of gross income.

Further, the regulations under section 118 specifically provide that capital contributions do not constitute income to an S corporation. In relevant part, section 1.118-1, Income Tax Regs., provides that "if a corporation requires additional funds for conducting

its business and obtains such funds through * * * payments by its shareholders * * * such amounts do not constitute income".

Also, in Black's Law Dictionary 209 (6th ed. 1990), "capital contribution" is defined as:

> Various means by which a shareholder makes additional funds available to the corporation (*i.e.*, placed at the risk of the business) without the receipt of additional stock. Such contributions are added to the basis of the shareholder's
>
> existing stock investment and do not generate income to the corporation. * * *

On the basis of the above, petitioners' capital contributions to G&D and W&N CAL are distinguishable from the discharge of indebtedness income that was at issue in *Gitlitz*.

We conclude that the *Gitlitz* holding that an S corporation's discharge of indebtedness income is to be treated as income to the S corporation for purposes of section 1366(a)(1) does not require that shareholder capital contributions to an S corporation are to be treated as income to the S corporation under section 1366(a)(1).

Petitioners also rely on *American Medical Ass'n v. United States*, 887 F.2d 760, 774-775 (7th Cir. 1989), in which the U.S. Court of Appeals for the Seventh Circuit held that a portion of annual membership fees placed in a nonprofit organization's

equity or capital account was to be treated as current income, not as noncurrent income or capital contributions to the organization. *See also Wash. Athletic Club v. United States*, 614 F.2d 670, 675 (9th Cir. 1980).

Both *Am. Med. Association* and *Wash. Athletic Club* are distinguishable. The funds placed in equity accounts in those cases were not paid to the nonprofit organizations as capital contributions, and they represented payments by the members for current year memberships, not to fund deferred capital expenditures of the organizations.

Petitioners also emphasize that section 1371(a) provides that "Except as otherwise provided in * * * [subchapter S] and except to the extent inconsistent with * * * [subchapter S]," the provisions of subchapter C are to apply to an S corporation, and petitioners argue that because section 1366(a)(1) of subchapter S provides a special rule for passing through to the shareholders items of income of the S corporation, the subchapter C general rules relating to the calculation of tax basis and to capital contributions should not apply to shareholders of S corporations. We disagree.

Before petitioners can calculate their tax bases in their loans under sections 1366(a)(1) and 1367(b)(2)(B), the gross income of both G&D and W&N CAL must be calculated. Sec. 1366(a)(1)(A). In making that gross income calculation the provisions of section 61 (regarding gross income) and the provisions of sections 101 through 136 (regarding specific exclusions from gross income such as the exclusion under section

118 of capital contributions to a corporation) apply. Sec. 1363(b). Once the gross income of G&D and of W&N CAL are calculated, section 1366(a)(1) and section 1367(b)(2)(B) apply in the calculation of petitioners' share of G&D and of W&N CAL's income and in the calculation of petitioners' tax bases in their stock in and in their loans to G&D and W&N CAL.

Thus, the provisions of section 118 apply in the calculation of an S corporation's gross income under section 1363(b) before the calculation of a shareholder's share of the income and losses of an S corporation under section 1366(a)(1) and before adjustments to a shareholder's tax basis under section 1367(b)(2)(B), and the provisions of section 118 are not inconsistent with the provisions of subchapter S.

We conclude that shareholder capital contributions are not to be treated as items of income to an S corporation under section 1366(a)(1) and are not to be treated as items of income used in calculating a "net increase" under section 1367(b)(2)(B) for the purpose of restoring or increasing a shareholder's tax basis in loans a shareholder made to an S corporation.

Petitioners' $ 1,437,248 capital contributions to G&D and W&N CAL do not constitute "tax-exempt income" to G&D and W&N CAL under section 1366(a)(1) or section 1.1366-1(a)(2)(viii), Income Tax Regs., and do not restore or increase petitioners' tax

bases in their loans to G&D and to W&N CAL under section 1367(b)(2)(B).

In the alternative, petitioners contend that petitioners' August 30, 2001, $ 1,074,456 capital contributions to G&D were made exclusively to obtain a release of petitioners' personal guaranties on G&D's bank loans and that the capital contributions to G&D should be deductible as ordinary losses under section 165(c)(1) or (2).[9]

Section 165(c)(1) provides that a taxpayer may deduct losses incurred in a trade or business, and section 165(c)(2) provides that a taxpayer may deduct losses that were incurred in a transaction entered into for profit.

Petitioners stipulated that they were not in the trade or business of providing loan guarantees, that they did not receive any compensation for guaranteeing the bank loans, and that they received no salary or wages from G&D. There is no credible evidence that petitioners guaranteed the bank loans for the purpose of making a profit therefrom. On the facts before us, we can only conclude, as we do, that petitioners' guarantees on the bank loans arose out of and related to each petitioner's status as a shareholder in G&D.

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[9] Petitioners' alternative loss argument relates only to petitioners' $ 1,074,456 Aug. 30, 2001, capital contributions to G&D.

Petitioners refer us to several old cases in which courts have held that a shareholder payment made to a corporation or a third party for the release from liability as a guarantor may be deductible as losses incurred in a transaction entered into for profit.

In *Lloyd-Smith v. Commissioner*, 40 B.T.A. 214, 223 (1939), *affd.* 116 F.2d 642 (2d Cir. 1941), the Board of Tax Appeals held that expenditures by a taxpayer in connection with readjustment of her liability as a guarantor of bonds qualified as deductible losses on a transaction entered into for profit because the taxpayer incurred the expenditures for the sole purpose of reducing her liability as guarantor.

In *Stamos v. Commissioner*, 22 T.C. 885, 888 (1954), we held that a taxpayer's legal fees incurred for the sole purpose of obtaining release of a loan guaranty qualified as deductible losses on a transaction entered into for profit.

In *Rushing v. Commissioner*, 58 T.C. 996, 1001 (1972), we noted:

> [The Tax] Court has held that certain payments which had their genesis in * * * [a taxpayer's] status as [guarantor] were payments which resulted in losses incurred in a transaction entered into for profit, deductible under section 165(c)(2). *See, for example,* * * * *Shea* [*v. Commissioner*], 36 T.C. 577 (1961), affirmed per curiam 327 F.2d 1002 (C.A. 5, 1964) * * * .

In *Shea v. Commissioner*, 36 T.C. 577, 582-583 (1961), affd. 327 F.2d 1002 (5th Cir. 1964), the Court held that a taxpayer's payments to third parties for the sole purpose of obtaining a release from his liability on a corporate guaranty qualified as deductible losses under section 165(c)(2).

In *Condit v. Commissioner*, 333 F.2d 585, 586-587 (10th Cir. 1964), *affg.* 40 T.C. 24 (1963), the fact that a taxpayer's "purpose * * * was to be relieved from personal liability as guarantor on debts" was key to the court's holding that an assignment of the taxpayer's stock to another shareholder was to be treated as a loss incurred in a transaction entered into for profit and thus as a deductible loss under section 165(c)(2).

Petitioners' August 30, 2001, $ 1,074,456 capital contributions to G&D are distinguishable from the payments involved in the above cases because petitioners clearly had multiple purposes in making the capital contributions to G&D. Petitioners stipulated that they made their August 30, 2001, $ 1,074,456 capital contributions to G&D in connection with the banks' release of petitioners' guaranties on the bank loans, with Gary's assumption of responsibility as guarantor on the bank loans, and with Gary's agreement to the reorganization of G&D, W&N, and W&N CAL. Thus, petitioners did not make the August 30, 2001, capital contributions to G&D for the sole purpose of being released from their guarantees on the bank loans.

In *Duke v. United States*, 39 A.F.T.R.2d 847, 77-1 USTC par. 9178 (S.D.N.Y. 1977), the District Court held that because the taxpayer made payments in exchange both for the release of the taxpayer's guaranty of a corporation's debt and for the contemporaneous sale of the taxpayer's stock, the taxpayer did not make the payments solely in exchange for the release of the taxpayer's guaranty and the taxpayer was not allowed to deduct the payments as ordinary losses under section 165(c).

We conclude that petitioners' August 30, 2001, $ 1,074,456 capital contributions to G&D were not incurred in a trade or business under section 165(c)(1) and were not incurred in a transaction entered into for profit under section 165(c)(2).

Petitioners are not entitled to an ordinary loss deduction under section 165(c)(1) or (2) relating to their $ 1,074,456 G&D capital contributions.

To reflect the foregoing,

Decisions will be entered for respondent.

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

At a Term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York on the 20th day of September, two thousand-ten,

_____x

Docket No. [s] : 09-1955 –ag

Ira Nathel, Tracy Nathel,
Sheldon Nathel, Ann M. Nathel,

Petitioners-Appellants,

v.

Commissioner of Internal Revenue,

Respondent-Appellee.

_____x

Appellant Ira Nathel, Tracy Nathel, Sheldon Nathel et al. having filed a petition for panel rehearing, or, in the alternative, for rehearing *en banc*, and the panel that determined the appeal having considered the request for panel rehearing, and the active members of the Court having considered the request for rehearing *en banc*,

IT IS HEREBY ORDERED that the petition is denied.

FOR THE COURT:
Catherine O'Hagan Wolfe,
Clerk of the Court

/s/ Catherine O'Hagan Wolfe

Hugh Janow Esq.
Law Offices of Hugh Janow, LLC
One Blue Hill Plaza Suite 1586
Pearl River, NY 10965

INTERNAL REVENUE CODE SECTIONS (26 USC), TREASURY REGULATIONS, AND SIXTEENTH AMENDMENT TO U.S. CONSTITUTION

§ 61 Gross income defined.

(a) General definition. Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

(b) Cross references. For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

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§ 108 Income from discharge of indebtedness.

(a) Exclusion from gross income.

(1) In general. Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if –

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent,

(C) the indebtedness discharged is qualified farm indebtedness,

(D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness, or

(E) the indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2013.

(2) Coordination of exclusions.

(A) Title 11 exclusion takes precedence. Subparagraphs (B), (C) (D), and (E) of paragraph (1) shall not apply to a discharge which occurs in a title 11 case.

(B) Insolvency exclusion takes precedence over qualified farm exclusion and qualified real property business exclusion. Subparagraphs (C) and (D) of paragraph (1) shall not apply to a discharge to the extent the taxpayer is insolvent.

(C) Principal residence exclusion takes precedence over insolvency exclusion unless elected otherwise. Paragraph (1)(B) shall not apply to a discharge to which paragraph (1)(E) applies unless the taxpayer elects to apply paragraph (1)(B) in lieu of paragraph (1)(E).

(3) Insolvency exclusion limited to amount of insolvency.

In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

(b) Reduction of tax attributes.

(1) In general.

The amount excluded from gross income under subparagraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).

(2) Tax attributes affected; order of reduction.

Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:

(A) NOL. Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

(B) General business credit. Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).

(C) Minimum tax credit. The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.

(D) Capital loss carryovers. Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.

(E) Basis reduction.

(i) In general. The basis of the property of the taxpayer.

(ii) Cross reference. For provisions for making the reduction described in clause (i), see section 1017.

(F) Passive activity loss and credit carryovers. Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.

(G) Foreign tax credit carryovers. Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

(3) Amount of reduction.

(A) In general. Except as provided in subparagraph (B), the reductions described in paragraph (2) shall be one dollar for each dollar excluded by subsection (a).

(B) Credit carryover reduction. The reductions described in subparagraphs (B), (C), and (G) shall be 33 ⅓ cents for each dollar excluded by subsection (a). The reduction described in subparagraph (F) in any passive activity credit carryover shall be 33 ⅓ cents for each dollar excluded by subsection (a).

(4) Ordering rules.

(A) Reductions made after determination of tax for year. The reductions described in paragraph (2) shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.

(B) Reductions under subparagraph (A) or (D) of paragraph (2). The reductions described in subparagraph (A) or (D) of paragraph (2) (as the case may be) shall be made

first in the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years from which each such carryover arose.

(C) Reductions under subparagraphs (B) and (G) of paragraph (2). The reductions described in subparagraphs (B) and (G) of paragraph (2) shall be made in the order in which carryovers are taken into account under this chapter for the taxable year of the discharge.

(5) Election to apply reduction first against depreciable property.

(A) In general. The taxpayer may elect to apply any portion of the reduction referred to in paragraph (1) to the reduction under section 1017 of the basis of the depreciable property of the taxpayer.

(B) Limitation. The amount to which an election under subparagraph (A) applies shall not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.

(C) Other tax attributes not reduced. Paragraph (2) shall not apply to any amount to which an election under this paragraph applies.

(c) Treatment of discharge of qualified real property business indebtedness.

(1) Basis reduction.

(A) In general. The amount excluded from gross income under subparagraph (D) of subsection (a)(1) shall be applied to reduce the basis of the depreciable real property of the taxpayer.

(B) Cross reference. For provisions making the reduction described in subparagraph (A), see section 1017.

(2) Limitations.

(A) Indebtedness in excess of value. The amount excluded under subparagraph (D) of subsection (a)(1) with respect to any qualified real property business indebtedness shall not exceed the excess (if any) of –

(i) the outstanding principal amount of such indebtedness (immediately before the discharge), over

(ii) the fair market value of the real property described in paragraph (3)(A) (as of such time), reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property (as of such time).

(B) Overall limitation. The amount excluded under subparagraph (D) of subsection (a)(1) shall not exceed the aggregate adjusted

bases of depreciable real property (determined after any reductions under subsections (b) and (g)) held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of such discharge).

(3) Qualified real property business indebtedness.

The term "qualified real property business indebtedness" means indebtedness which –

(A) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property,

(B) was incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, is qualified acquisition indebtedness, and

(C) with respect to which such taxpayer makes an election to have this paragraph apply.

Such term shall not include qualified farm indebtedness. Indebtedness under subparagraph (B) shall include indebtedness resulting from the refinancing of indebtedness under subparagraph (B) (or this sentence), but only to the extent it does not exceed the amount of the indebtedness being refinanced.

(4) Qualified acquisition indebtedness.

For purposes of paragraph (3)(B), the term "qualified acquisition indebtedness" means, with respect to any real property described in paragraph (3)(A), indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such property.

(5) Regulations.

The Secretary shall issue such regulations as are necessary to carry out this subsection, including regulations preventing the abuse of this subsection through cross-collateralization or other means.

(d) Meaning of terms; special rules relating to certain provisions.

(1) Indebtedness of taxpayer.

For purposes of this section, the term "indebtedness of the taxpayer" means any indebtedness –

(A) for which the taxpayer is liable, or

(B) subject to which the taxpayer holds property.

(2) Title 11 case.

For purposes of this section, the term "title 11 case" means a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

(3) Insolvent.

For purposes of this section, the term "insolvent" means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

(4) Repealed.

(5) Depreciable property.

The term "depreciable property" has the same meaning as when used in section 1017.

(6) Certain provisions to be applied at partner level.

In the case of a partnership, subsections (a), (b), (c) and (g) shall be applied at the partner level.

(7) Special rules for S corporation.

(A) Certain provisions to be applied at corporate level. In the case of an S corporation, subsections (a), (b), (c), and (g) shall be applied at the corporate level, including by not taking into account under section 1366(a) any amount excluded under subsection (a) of this section.

(B) Reduction in carryover of disallowed losses and deductions. In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2), any loss or deduction which is disallowed for the taxable year of

the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year. The preceding sentence shall not apply to any discharge to the extent that subsection (a)(1)(D) applies to such discharge.

(C) Coordination with basis adjustments under section 1367(b)(2). For purposes of subsection (e)(6), a shareholder's adjusted basis in indebtedness of an S corporation shall be determined without regard to any adjustments made under section 1367(b)(2).

(8) Reductions of tax attributes in title 11 cases of individuals to be made by estate.

In any case under chapter 7 or 11 of title 11 of the United States Code to which section 1398 applies, for purposes of paragraphs (1) and (5) of subsection (b) the estate (and not the individual) shall be treated as the taxpayer. The preceding sentence shall not apply for purposes of applying section 1017 to property transferred by the estate to the individual.

(9) Time for making election, etc.

(A) Time. An election under paragraph (5) of subsection (b) or under paragraph (3)(C) of subsection (c) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary.

(B) Revocation only with consent. An election referred to in subparagraph (A), once

made, may be revoked only with the consent of the Secretary.

(C) Manner. An election referred to in subparagraph (A) shall be made in such manner as the Secretary may by regulations prescribe.

(10) Cross reference. For provision that no reduction is to be made in the basis of exempt property of an individual debtor, see section 1017(c)(1).

(e) General rules for discharge of indebtedness (including discharges not in title 11 cases or insolvency).

For purposes of this title –

(1) No other insolvency exception.

Except as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness.

(2) Income not realized to extent of lost deductions.

No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.

(3) Adjustments for unamortized premium and discount.

The amount taken into account with respect to any discharge shall be properly adjusted for

unamortized premium and unamortized discount with respect to the indebtedness discharged.

(4) Acquisition of indebtedness by person related to debtor.

(A) Treated as acquisition by debtor. For purposes of determining income of the debtor from discharge of indebtedness, to the extent provided in regulations prescribed by the Secretary, the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in section 267(b) or 707(b)(1) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor. Such regulations shall provide for such adjustments in the treatment of any subsequent transactions involving the indebtedness as may be appropriate by reason of the application of the preceding sentence.

(B) Members of family. For purposes of this paragraph, sections 267(b) and 707(b)(1) shall be applied as if section 267(c)(4) provided that the family of an individual consists of the individual's spouse, the individual's children, grandchildren, and parents, and any spouse of the individual's children or grandchildren.

(C) Entities under common control treated as related. For purposes of this paragraph, two entities which are treated as a single employer under subsection (b) or (c) of section 414 shall be treated as bearing a relationship

to each other which is described in section 267(b).

(5) Purchase-money debt reduction for solvent debtor treated as price reduction.

If –

(A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,

(B) such reduction does not occur –

(i) in a title 11 case, or

(ii) when the purchaser is insolvent, and

(C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness, then such reduction shall be treated as a purchase price adjustment.

(6) Indebtedness contributed to capital.

Except as provided in regulations, for purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital –

(A) section 118 shall not apply, but

(B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

(7) Recapture of gain on subsequent sale of stock.

(A) In general. If a creditor acquires stock of a debtor corporation in satisfaction of such corporation's indebtedness, for purposes of section 1245 –

(i) such stock (and any other property the basis of which is determined in whole or in part by reference to the adjusted basis of such stock) shall be treated as section 1245 property,

(ii) the aggregate amount allowed to the creditor –

(I) as deductions under subsection (a) or (b) of section 166 (by reason of the worthlessness or partial worthlessness of the indebtedness), or

(II) as an ordinary loss on the exchange, shall be treated as an amount allowed as a deduction for depreciation, and

(iii) an exchange of such stock qualifying under section 354(a), 355(a), or 356(a) shall be treated as an exchange to which section 1245(b)(3) applies.

The amount determined under clause (ii) shall be reduced by the amount (if any) included in the creditor's gross income on the exchange.

(B) Special rule for cash basis taxpayers. In the case of any creditor who computes his

taxable income under the cash receipts and disbursements method, proper adjustment shall be made in the amount taken into account under clause (ii) of subparagraph (A) for any amount which was not included in the creditor's gross income but which would have been included in such gross income if such indebtedness had been satisfied in full.

(C) Stock of parent corporation. For purposes of this paragraph, stock of a corporation in control (within the meaning of section 368(c)) of the debtor corporation shall be treated as stock of the debtor corporation.

(D) Treatment of successor corporation. For purposes of this paragraph, the term "debtor corporation" includes a successor corporation.

(E) Partnership rule. Under regulations prescribed by the Secretary, rules similar to the rules of the foregoing subparagraphs of this paragraph shall apply with respect to the indebtedness of a partnership.

(8) Indebtedness satisfied by corporate stock or partnership interest.

For purposes of determining income of a debtor from discharge of indebtedness, if –

(A) a debtor corporation transfers stock, or

(B) a debtor partnership transfers a capital or profits interest in such partnership, to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such corporation or

partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock or interest. In the case of any partnership, any discharge of indebtedness income recognized under this paragraph shall be included in the distributive shares of taxpayers which were the partners in the partnership immediately before such discharge.

(9) Discharge of indebtedness income not taken into account in determining whether entity meets REIT qualifications.

Any amount included in gross income by reason of the discharge of indebtedness shall not be taken into account for purposes of paragraphs (2) and (3) of section 856(c).

(10) Indebtedness satisfied by issuance of debt instrument.

(A) In general. For purposes of determining income of a debtor from discharge of indebtedness, if a debtor issues a debt instrument in satisfaction of indebtedness, such debtor shall be treated as having satisfied the indebtedness with an amount of money equal to the issue price of such debt instrument.

(B) Issue price. For purposes of subparagraph (A), the issue price of any debt instrument shall be determined under sections 1273 and 1274. For purposes of the preceding sentence, section 1273(b)(4) shall be applied by reducing the stated redemption price of

any instrument by the portion of such stated redemption price which is treated as interest for purposes of this chapter.

(f) Student loans.

(1) In general.

In the case of an individual, gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of any student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers.

(2) Student loan.

For purposes of this subsection, the term "student loan" means any loan to an individual to assist the individual in attending an educational organization described in section 170(b)(1)(A)(ii) made by –

(A) the United States, or an instrumentality or agency thereof,

(B) a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof,

(C) a public benefit corporation –

(i) which is exempt from taxation under section 501(c)(3),

(ii) which has assumed control over a State, county, or municipal hospital, and

(iii) whose employees have been deemed to be public employees under State law, or

(D) any educational organization described in section 170(b)(1)(A)(ii) if such loan is made –

(i) pursuant to an agreement with any entity described in subparagraph (A), (B), or (C) under which the funds from which the loan was made were provided to such educational organization, or

(ii) pursuant to a program of such educational organization which is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs and under which the services provided by the students (or former students) are for or under the direction of a governmental unit or an organization described in section 501(c)(3) and exempt from tax under section 501(a).

The term "student loan" includes any loan made by an educational organization described in section 170(b)(1)(A)(ii) or by an organization exempt from tax under section 501(a) to refinance a loan to an individual to assist the individual in attending any such educational organization but only if the refinancing loan is pursuant to a program of the refinancing organization which is designed as described in subparagraph (D)(ii).

(3) Exception for discharges on account of services performed for certain lenders.

Paragraph (1) shall not apply to the discharge of a loan made by an organization described in paragraph (2)(D) if the discharge is on account of services performed for either such organization.

(4) Payments under National Health Service Corps loan repayment program and certain State loan repayment programs.

In the case of an individual, gross income shall not include any amount received under section 338B(g) of the Public Health Service Act, under a State program described in section 338I of such Act, or under any other State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas (as determined by such State).

(g) Special rules for discharge of qualified farm indebtedness.

(1) Discharge must be by qualified person.

(A) In general. Subparagraph (C) of subsection (a)(1) shall apply only if the discharge is by a qualified person.

(B) Qualified person. For purposes of subparagraph (A), the term "qualified person" has the meaning given to such term by section 49(a)(1)(D)(iv); except that such term shall include any Federal, State, or local government or agency or instrumentality thereof.

(2) Qualified farm indebtedness.

For purposes of this section, indebtedness of a taxpayer shall be treated as qualified farm indebtedness if –

(A) such indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and

(B) 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs is attributable to the trade or business of farming.

(3) Amount excluded cannot exceed sum of tax attributes and business and investment assets.

(A) In general. The amount excluded under subparagraph (C) of subsection (a)(1) shall not exceed the sum of –

(i) the adjusted tax attributes of the taxpayer, and

(ii) the aggregate adjusted bases of qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.

(B) Adjusted tax attributes. For purposes of subparagraph (A), the term "adjusted tax attributes" means the sum of the tax attributes described in subparagraphs (A), (B), (C), (D),

(F), and (G) of subsection (b)(2) determined by taking into account $3 for each $1 of the attributes described in subparagraphs (B), (C), and (G) of subsection (b)(2) and the attribute described in subparagraph (F) of subsection (b)(2) to the extent attributable to any passive activity credit carryover.

(C) Qualified property. For purposes of this paragraph, the term "qualified property" means any property which is used or is held for use in a trade or business or for the production of income.

(D) Coordination with insolvency exclusion. For purposes of this paragraph, the adjusted basis of any qualified property and the amount of the adjusted tax attributes shall be determined after any reduction under subsection (b) by reason of amounts excluded from gross income under subsection (a)(1)(B).

(h) Special rules relating to qualified principal residence indebtedness.

(1) Basis reduction.

The amount excluded from gross income by reason of subsection (a)(1)(E) shall be applied to reduce (but not below zero) the basis of the principal residence of the taxpayer.

(2) Qualified principal residence indebtedness.

For purposes of this section, the term "qualified principal residence indebtedness" means acquisition indebtedness (within the meaning of section

163(h)(3)(B), applied by substituting "$2,000,000 ($1,000,000" for "$1,000,000 ($500,000" in clause (ii) thereof) with respect to the principal residence of the taxpayer.

(3) Exception for certain discharges not related to taxpayer's financial conditions.

Subsection (a)(1)(E) shall not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.

(4) Ordering rules.

If any loan is discharged, in whole or in part, and only a portion of such loan is qualified principal residence indebtedness, subsection (a)(1)(E) shall apply only to so much of the amount discharged as exceeds the amount of the loan (as determined immediately before such discharge) which is not qualified principal residence indebtedness.

(5) Principal residences.

For purposes of this subsection, the term "principal residence" has the same meaning as when used in section 121.

(i) Deferral and ratable inclusion of income arising from business indebtedness discharged by the reacquisition of a debt instrument.

(1) In general.

At the election of the taxpayer, income from the discharge of indebtedness in connection with the

reacquisition after December 31, 2008, and before January 1, 2011, of an applicable debt instrument shall be includible in gross income ratably over the 5-taxable-year period beginning with –

(A) in the case of a reacquisition occurring in 2009, the fifth taxable year following the taxable year in which the reacquisition occurs, and

(B) in the case of a reacquisition occurring in 2010, the fourth taxable year following the taxable year in which the reacquisition occurs.

(2) Deferral of deduction for original issue discount in debt for debt exchanges.

(A) In general. If, as part of a reacquisition to which paragraph (1) applies, any debt instrument is issued for the applicable debt instrument being reacquired (or is treated as so issued under subsection (e)(4) and the regulations thereunder) and there is any original issue discount determined under subpart A of part V of subchapter P of this chapter with respect to the debt instrument so issued –

(i) except as provided in clause (ii), no deduction otherwise allowable under this chapter shall be allowed to the issuer of such debt instrument with respect to the portion of such original issue discount which –

(I) accrues before the 1st taxable year in the 5-taxable-year period in

which income from the discharge of indebtedness attributable to the reacquisition of the debt instrument is includible under paragraph (1), and

(II) does not exceed the income from the discharge of indebtedness with respect to the debt instrument being reacquired, and

(ii) the aggregate amount of deductions disallowed under clause (i) shall be allowed as a deduction ratably over the 5-taxable-year period described in clause (i)(I).

If the amount of the original issue discount accruing before such 1st taxable year exceeds the income from the discharge of indebtedness with respect to the applicable debt instrument being reacquired, the deductions shall be disallowed in the order in which the original issue discount is accrued.

(B) Deemed debt for debt exchanges. For purposes of subparagraph (A), if any debt instrument is issued by an issuer and the proceeds of such debt instrument are used directly or indirectly by the issuer to reacquire an applicable debt instrument of the issuer, the debt instrument so issued shall be treated as issued for the debt instrument being reacquired. If only a portion of the proceeds from a debt instrument are so used, the rules of subparagraph (A) shall apply to the portion of any original issue discount on the newly issued debt instrument which is

equal to the portion of the proceeds from such instrument used to reacquire the outstanding instrument.

(3) Applicable debt instrument. For purposes of this subsection –

(A) Applicable debt instrument. The term "applicable debt instrument" means any debt instrument which was issued by –

(i) a C corporation, or

(ii) any other person in connection with the conduct of a trade or business by such person.

(B) Debt instrument. The term "debt instrument" means a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness (within the meaning of section 1275(a)(1)).

(4) Reacquisition.

For purposes of this subsection –

(A) In general. The term "reacquisition" means, with respect to any applicable debt instrument, any acquisition of the debt instrument by –

(i) the debtor which issued (or is otherwise the obligor under) the debt instrument, or

(ii) a related person to such debtor.

(B) Acquisition. The term "acquisition" shall, with respect to any applicable debt instrument, include an acquisition of the debt instrument for cash, the exchange of the debt instrument for another debt instrument (including an exchange resulting from a modification of the debt instrument), the exchange of the debt instrument for corporate stock or a partnership interest, and the contribution of the debt instrument to capital. Such term shall also include the complete forgiveness of the indebtedness by the holder of the debt instrument.

(5) Other definitions and rules.

For purposes of this subsection –

(A) Related person. The determination of whether a person is related to another person shall be made in the same manner as under subsection (e)(4).

(B) Election.

(i) In general. An election under this subsection with respect to any applicable debt instrument shall be made by including with the return of tax imposed by chapter 1 for the taxable year in which the reacquisition of the debt instrument occurs a statement which –

(I) clearly identifies such instrument, and

(II) includes the amount of income to which paragraph (1) applies and

such other information as the Secretary may prescribe.

(ii) Election irrevocable. Such election, once made, is irrevocable.

(iii) Pass through entities. In the case of a partnership, S corporation, or other pass through entity, the election under this subsection shall be made by the partnership, the S corporation, or other entity involved.

(C) Coordination with other exclusions. If a taxpayer elects to have this subsection apply to an applicable debt instrument, subparagraphs (A), (B), (C), and (D) of subsection (a)(1) shall not apply to the income from the discharge of such indebtedness for the taxable year of the election or any subsequent taxable year.

(D) Acceleration of deferred items.

(i) In general. In the case of the death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case), the cessation of business by the taxpayer, or similar circumstances, any item of income or deduction which is deferred under this subsection (and has not previously been taken into account) shall be taken into account in the taxable year in which such event occurs (or in the case of a title 11 case, the day before the petition is filed).

(ii) Special rule for pass thru entities. The rule of clause (i) shall also apply in the case of the sale or exchange or redemption of an interest in a partnership, S corporation, or other pass through entity by a partner, shareholder, or other person holding an ownership interest in such entity.

(6) Special rule for partnerships.

In the case of a partnership, any income deferred under this subsection shall be allocated to the partners in the partnership immediately before the discharge in the manner such amounts would have been included in the distributive shares of such partners under section 704 if such income were recognized at such time. Any decrease in a partner's share of partnership liabilities as a result of such discharge shall not be taken into account for purposes of section 752 at the time of the discharge to the extent it would cause the partner to recognize gain under section 731. Any decrease in partnership liabilities deferred under the preceding sentence shall be taken into account by such partner at the same time, and to the extent remaining in the same amount, as income deferred under this subsection is recognized.

(7) Secretarial authority.

The Secretary may prescribe such regulations, rules, or other guidance as may be necessary or appropriate for purposes of applying this subsection, including –

(A) extending the application of the rules of paragraph (5)(D) to other circumstances where appropriate,

(B) requiring reporting of the election (and such other information as the Secretary may require) on returns of tax for subsequent taxable years, and

(C) rules for the application of this subsection to partnerships, S corporations, and other pass-thru entities, including for the allocation of deferred deductions.

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§ 118 Contributions to the capital of a corporation.

(a) General rule.

In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

(b) Contributions in aid of construction, etc.

For purposes of subsection (a), except as provided in subsection (c), the term "contribution to the capital of the taxpayer" does not include any contribution in aid of construction or any other contribution as a customer or potential customer.

(c) Special rules for water and sewerage disposal utilities.

(1) General rule.

For purposes of this section, the term "contribution to the capital of the taxpayer" includes any amount of money or other property received from any person (whether or not a shareholder) by a regulated public utility which provides water or sewerage disposal services if –

(A) such amount is a contribution in aid of construction,

(B) in the case of contribution of property other than water or sewerage disposal facilities, such amount meets the requirements of the expenditure rule of paragraph (2), and

(C) such amount (or any property acquired or constructed with such amount) is not included in the taxpayer's rate base for rate-making purposes.

(2) Expenditure rule.

An amount meets the requirements of this paragraph if –

(A) an amount equal to such amount is expended for the acquisition or construction of tangible property described in section 1231(b) –

(i) which is the property for which the contribution was made or is of the same type as such property, and

(ii) which is used predominantly in the trade or business of furnishing water or sewerage disposal services,

(B) the expenditure referred to in subparagraph (A) occurs before the end of the second taxable year after the year in which such amount was received, and

(C) accurate records are kept of the amounts contributed and expenditures made, the expenditures to which contributions are allocated, and the year in which the contributions and expenditures are received and made.

(3) Definitions.

For purposes of this subsection –

(A) Contribution in aid of construction. The term "contribution in aid of construction" shall be defined by regulations prescribed by the Secretary, except that such term shall not include amounts paid as service charges for starting or stopping services.

(B) Predominantly. The term "predominantly" means 80 percent or more.

(C) Regulated public utility. The term "regulated public utility" has the meaning given such term by section 7701(a)(33), except that such term shall not include any utility which is not required to provide water or sewerage disposal services to members of the general public in its service area.

(4) Disallowance of deductions and credits; adjusted basis.

Notwithstanding any other provision of this subtitle, no deduction or credit shall be allowed for, or by reason of, any expenditure which constitutes a contribution in aid of construction to which this subsection applies. The adjusted basis of any property acquired with contributions in aid of construction to which this subsection applies shall be zero.

(d) Statute of limitations.

If the taxpayer for any taxable year treats an amount as a contribution to the capital of the taxpayer described in subsection (c), then –

(1) the statutory period for the assessment of any deficiency attributable to any part of such amount shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may prescribe) of –

(A) the amount of the expenditure referred to in subparagraph (A) of subsection (c)(2),

(B) the taxpayer's intention not to make the expenditures referred to in such subparagraph, or

(C) a failure to make such expenditure within the period described in subparagraph (B) of subsection (c)(2), and

(2) such deficiency may be assessed before the expiration of such 3-year period notwithstanding

the provisions of any other law or rule of law which would otherwise prevent such assessment.

(e) Cross references.

(1) For basis of property acquired by a corporation through a contribution to its capital, see section 362.

(2) For special rules in the case of contributions of indebtedness, see section 108(e)(6).

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§ 1366 Pass-thru of items to shareholders.

(a) Determination of shareholder's tax liability.

(1) In general.

In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and

(B) nonseparately computed income or loss.

For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).

(2) Nonseparately computed income or loss defined.

For purposes of this subchapter, the term "nonseparately computed income or loss" means gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items described in paragraph (1)(A).

(b) Character passed thru.

The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

(c) Gross income of a shareholder.

In any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation.

(d) Special rules for losses and deductions.

(1) Cannot exceed shareholder's basis in stock and debt.

The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

(2) Indefinite carryover of disallowed losses and deductions.

(A) In general. Except as provided in subparagraph (B), any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

(B) Transfers of stock between spouses or incident to divorce. In the case of any transfer described in section 1041(a) of stock of an S corporation, any loss or deduction described in subparagraph (A) with respect such stock shall be treated as incurred by the corporation in the succeeding taxable year with respect to the transferee.

(3) Carryover of disallowed losses and deductions to post-termination transition period.

(A) In general. If for the last taxable year of a corporation for which it was an S corporation a loss or deduction was disallowed by reason of paragraph (1), such loss or

deduction shall be treated as incurred by the shareholder on the last day of any post-termination transition period.

(B) Cannot exceed shareholder's basis in stock. The aggregate amount of losses and deductions taken into account by a shareholder under subparagraph (A) shall not exceed the adjusted basis of the shareholder's stock in the corporation (determined at the close of the last day of the post-termination transition period and without regard to this paragraph).

(C) Adjustment in basis of stock. The shareholder's basis in the stock of the corporation shall be reduced by the amount allowed as a deduction by reason of this paragraph.

(D) At-risk limitations. To the extent that any increase in adjusted basis described in subparagraph (B) would have increased the shareholder's amount at risk under section 465 if such increase had occurred on the day preceding the commencement of the post-termination transition period, rules similar to the rules described in subparagraphs (A) through (C) shall apply to any losses disallowed by reason of section 465(a).

(4) Application of limitation on charitable contributions.

In the case of any charitable contribution of property to which the second sentence of section

1367(a)(2) applies, paragraph (1) shall not apply to the extent of the excess (if any) of –

(A) the shareholder's pro rata share of such contribution, over

(B) the shareholder's pro rata share of the adjusted basis of such property.

(e) Treatment of family group.

If an individual who is a member of the family (within the meaning of section 704(e)(3)) of one or more shareholders of an S corporation renders services for the corporation or furnishes capital to the corporation without receiving reasonable compensation therefor, the Secretary shall make such adjustments in the items taken into account by such individual and such shareholders as may be necessary in order to reflect the value of such services or capital.

(f) Special rules.

(1) Subsection (a) not to apply to credit allowable under section 34.

Subsection (a) shall not apply with respect to any credit allowable under section 34 (relating to certain uses of gasoline and special fuels).

(2) Treatment of tax imposed on built-in gains.

If any tax is imposed under section 1374 for any taxable year on an S corporation, for purposes of subsection (a), the amount so imposed shall be treated as a loss sustained by the S corporation during such taxable year. The character of such

loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.

(3) Reduction in pass-thru for tax imposed on excess net passive income.

If any tax is imposed under section 1375 for any taxable year on an S corporation, for purposes of subsection (a), each item of passive investment income shall be reduced by an amount which bears the same ratio to the amount of such tax as –

(A) the amount of such item, bears to

(B) the total passive investment income for the taxable year.

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§ 1367 Adjustments to basis of stock of shareholders, etc.

(a) General rule.

(1) Increases in basis.

The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:

(A) the items of income described in subparagraph (A) of section 1366(a)(1),

(B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion.

(2) Decreases in basis.

The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

(A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,

(B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),

(C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1),

(D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and

(E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(11)(B).

The decrease under subparagraph (B) by reason of a charitable contribution (as defined in section

170(c)) of property shall be the amount equal to the shareholder's pro rata share of the adjusted basis of such property. The preceding sentence shall not apply to contributions made in taxable years beginning after December 31, 2009.

(b) Special rules.

(1) Income items.

An amount which is required to be included in the gross income of a shareholder and shown on his return shall be taken into account under subparagraph (A) or (B) of subsection (a)(1) only to the extent such amount is included in the shareholder's gross income on his return, increased or decreased by any adjustment of such amount in a redetermination of the shareholder's tax liability.

(2) Adjustments in basis of indebtedness.

(A) Reduction of basis. If for any taxable year the amounts specified in subparagraphs (B), (C), (D), and (E) of subsection (a)(2) exceed the amount which reduces the shareholder's basis to zero, such excess shall be applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.

(B) Restoration of basis. If for any taxable year beginning after December 31, 1982, there is a reduction under subparagraph (A) in the shareholder's basis in the indebtedness of an S corporation to a shareholder, any net increase (after the application of paragraphs (1) and (2) of subsection (a)) for any subsequent taxable year shall be

applied to restore such reduction in basis before any of it may be used to increase the shareholder's basis in the stock of the S corporation.

(3) Coordination with sections 165(g) and 166(d).

This section and section 1366 shall be applied before the application of sections 165(g) and 166(d) to any taxable year of the shareholder or the corporation in which the security or debt becomes worthless.

(4) Adjustments in case of inherited stock.

(A) In general. If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest, devise, or inheritance, section 691 shall be applied with respect to any item of income of the S corporation in the same manner as if the decedent had held directly his pro rata share of such item.

(B) Adjustments to basis. The basis determined under section 1014 of any stock in an S corporation shall be reduced by the portion of the value of the stock which is attributable to items constituting income in respect of the decedent.

Reg §1.1366-1. Shareholder's share of items of an S corporation.

Caution: The Treasury has not yet amended Reg § 1.1366-1 to reflect changes made by P.L. 110-246

(a) **Determination of shareholder's tax liability.**

(1) In general. An S corporation must report, and a shareholder is required to take into account in the shareholder's return, the shareholder's pro rata share, whether or not distributed, of the S corporation's items of income, loss, deduction, or credit described in paragraphs (a)(2), (3), and (4) of this section. A shareholder's pro rata share is determined in accordance with the provisions of section 1377(a) and the regulations thereunder. The shareholder takes these items into account in determining the shareholder's taxable income and tax liability for the shareholder's taxable year with or within which the taxable year of the corporation ends. If the shareholder dies (or if the shareholder is an estate or trust and the estate or trust terminates) before the end of the taxable year of the corporation, the shareholder's pro rata share of these items is taken into account on the shareholder's final return. For the limitation on allowance of a shareholder's pro rata share of S corporation losses or deductions, see section 1366(d) and §1.1366-2.

(2) Separately stated items of income, loss, deduction, or credit. Each shareholder must take into account separately the shareholder's pro rata share of any item of income (including tax-exempt income), loss, deduction, or credit of the

S corporation that if separately taken into account by any shareholder could affect the shareholder's tax liability for that taxable year differently than if the shareholder did not take the item into account separately. The separately stated items of the S corporation include, but are not limited to, the following items –

(i) The corporation's combined net amount of gains and losses from sales or exchanges of capital assets grouped by applicable holding periods, by applicable rate of tax under section 1(h), and by any other classification that may be relevant in determining the shareholder's tax liability;

(ii) The corporation's combined net amount of gains and losses from sales or exchanges of property described in section 1231 (relating to property used in the trade or business and involuntary conversions), grouped by applicable holding periods, by applicable rate of tax under section 1(h), and by any other classification that may be relevant in determining the shareholder's tax liability;

(iii) Charitable contributions, grouped by the percentage limitations of section 170(b), paid by the corporation within the taxable year of the corporation;

(iv) The taxes described in section 901 that have been paid (or accrued) by the corporation to foreign countries or to possessions of the United States;

(v) Each of the corporation's separate items involved in the determination of credits against tax allowable under part IV of subchapter A (section 21 and following) of the Internal Revenue Code, except for any credit allowed under section 34 (relating to certain uses of gasoline and special fuels);

(vi) Each of the corporation's separate items of gains and losses from wagering transactions (section 165(d)); soil and water conservation expenditures (section 175); deduction under an election to expense certain depreciable business expenses (section 179); medical, dental, etc., expenses (section 213); the additional itemized deductions for individuals provided in part VII of subchapter B (section 212 and following) of the Internal Revenue Code; and any other itemized deductions for which the limitations on itemized deductions under sections 67 or 68 applies;

(vii) Any of the corporation's items of portfolio income or loss, and expenses related thereto, as defined in the regulations under section 469;

(viii) The corporation's tax-exempt income. For purposes of subchapter S, tax-exempt income is income that is permanently excludible from gross income in all circumstances in which the applicable provision of the Internal Revenue Code applies. For example, income that is excludible from gross income under

section 101 (certain death benefits) or section 103 (interest on state and local bonds) is tax-exempt income, while income that is excludible from gross income under section 108 (income from discharge of indebtedness) or section 109 (improvements by lessee on lessor's property) is not tax-exempt income;

(ix) The corporation's adjustments described in sections 56 and 58, and items of tax preference described in section 57; and

(x) Any item identified in guidance (including forms and instructions) issued by the Commissioner as an item required to be separately stated under this paragraph (a)(2).

(3) Nonseparately computed income or loss. Each shareholder must take into account separately the shareholder's pro rata share of the nonseparately computed income or loss of the S corporation. For this purpose, nonseparately computed income or loss means the corporation's gross income less the deductions allowed to the corporation under chapter 1 of the Internal Revenue Code, determined by excluding any item requiring separate computation under paragraph (a)(2) of this section.

(4) Separate activities requirement. An S corporation must report, and each shareholder must take into account in the shareholder's return, the shareholder's pro rata share of an S corporation's items of income, loss, deduction, or credit described in paragraphs (a)(2) and (3) of this section for each of the corporation's activities as

defined in section 469 and the regulations thereunder.

(5) Aggregation of deductions or exclusions for purposes of limitations.

(i) In general. A shareholder aggregates the shareholder's separate deductions or exclusions with the shareholder's pro rata share of the S corporation's separately stated deductions or exclusions in determining the amount of any deduction or exclusion allowable to the shareholder under subtitle A of the Internal Revenue Code as to which a limitation is imposed.

(ii) Example. The provisions of paragraph (a)(5)(i) of this section are illustrated by the following example: *Example.* In 1999, Corporation M, a calendar year S corporation, purchases and places in service section 179 property costing $10,000. Corporation M elects to expense the entire cost of the property. Shareholder A owns 50 percent of the stock of Corporation M. Shareholder A's pro rata share of this item after Corporation M applies the section 179(b) limitations is $5,000. Because the aggregate amount of Shareholder A's pro rata share and separately acquired section 179 expense may not exceed $19,000 (the aggregate maximum cost that may be taken into account under section 179(a) for the applicable taxable year), Shareholder A may elect to expense up to $14,000 of separately acquired section 179 property that is purchased and placed in

service in 1999, subject to the limitations of section 179(b).

(b) Character of items constituting pro rata share.

(1) In general. Except as provided in paragraph (b)(2) or (3) of this section, the character of any item of income, loss, deduction, or credit described in section 1366(a)(1)(A) or (B) and paragraph (a) of this section is determined for the S corporation and retains that character in the hands of the shareholder. For example, if an S corporation has capital gain on the sale or exchange of a capital asset, a shareholder's pro rata share of that gain will also be characterized as a capital gain regardless of whether the shareholder is otherwise a dealer in that type of property. Similarly, if an S corporation engages in an activity that is not for profit (as defined in section 183), a shareholder's pro rata share of the S corporation's deductions will be characterized as not for profit. Also, if an S corporation makes a charitable contribution to an organization qualifying under section 170(b)(1)(A), a shareholder's pro rata share of the S corporation's charitable contribution will be characterized as made to an organization qualifying under section 170(b)(1)(A).

(2) Exception for contribution of noncapital gain property. If an S corporation is formed or availed of by any shareholder or group of shareholders for a principal purpose of selling or exchanging contributed property that in the hands of the shareholder or shareholders would not have produced capital gain if sold or exchanged by the

shareholder or shareholders, then the gain on the sale or exchange of the property recognized by the corporation is not treated as a capital gain.

(3) Exception for contribution of capital loss property. If an S corporation is formed or availed of by any shareholder or group of shareholders for a principal purpose of selling or exchanging contributed property that in the hands of the shareholder or shareholders would have produced capital loss if sold or exchanged by the shareholder or shareholders, then the loss on the sale or exchange of the property recognized by the corporation is treated as a capital loss to the extent that, immediately before the contribution, the adjusted basis of the property in the hands of the shareholder or shareholders exceeded the fair market value of the property.

(c) Gross income of a shareholder.

(1) In general. Where it is necessary to determine the amount or character of the gross income of a shareholder, the shareholder's gross income includes the shareholder's pro rata share of the gross income of the S corporation. The shareholder's pro rata share of the gross income of the S corporation is the amount of gross income of the corporation used in deriving the shareholder's pro rata share of S corporation taxable income or loss (including items described in section 1366(a)(1)(A) or (B) and paragraph (a) of this section). For example, a shareholder is required to include the shareholder's pro rata share of S corporation gross income in computing the shareholder's gross income for the purposes of

determining the necessity of filing a return (section 6012(a)) and the shareholder's gross income derived from farming (sections 175 and 6654(i)).

(2) Gross income for substantial omission of items.

(i) In general. For purposes of determining the applicability of the 6-year period of limitation on assessment and collection provided in section 6501(e) (relating to omission of more than 25 percent of gross income), a shareholder's gross income includes the shareholder's pro rata share of S corporation gross income (as described in section 6501(e)(1)(A)(i)). In this respect, the amount of S corporation gross income used in deriving the shareholder's pro rata share of any item of S corporation income, loss, deduction, or credit (as included or disclosed in the shareholder's return) is considered as an amount of gross income stated in the shareholder's return for purposes of section 6501(e).

(ii) Example. The following example illustrates the provisions of paragraph (c)(2)(i) of this section: *Example.* Shareholder A, an individual, owns 25 percent of the stock of Corporation N, an S corporation that has $10,000 gross income and $2,000 taxable income. A reports only $300 as A's pro rata share of N's taxable income. A should have reported $500 as A's pro rata share of taxable income, derived from A's pro rata share, $2,500, of N's gross income. Because A's

return included only $300 without a disclosure meeting the requirements of section 6501(e)(1)(A)(ii) describing the difference of $200, A is regarded as having reported on the return only $1,500 ($300/$500 of $2,500) as gross income from N.

(d) Shareholders holding stock subject to community property laws. If a shareholder holds S corporation stock that is community property, then the shareholder's pro rata share of any item or items listed in paragraphs (a)(2), (3), and (4) of this section with respect to that stock is reported by the husband and wife in accordance with community property rules.

(e) Net operating loss deduction of shareholder of S corporation. For purposes of determining a net operating loss deduction under section 172, a shareholder of an S corporation must take into account the shareholder's pro rata share of items of income, loss, deduction, or credit of the corporation. See section 1366(b) and paragraph (b) of this section for rules on determining the character of the items. In determining under section 172(d)(4) the nonbusiness deductions allowable to a shareholder of an S corporation (arising from both corporation sources and any other sources), the shareholder separately takes into account the shareholder's pro rata share of the deductions of the corporation that are not attributable to a trade or business and combines this amount with the shareholder's nonbusiness deductions from any other sources. The shareholder also separately takes into

account the shareholder's pro rata share of the gross income of the corporation not derived from a trade or business and combines this amount with the shareholder's nonbusiness income from all other sources. See section 172 and the regulations thereunder.

(f) Cross-reference. For rules relating to the consistent tax treatment of subchapter S items, see section 6037(c).

Amendment XVI – To the United States Constitution

(Ratified February 3, 1913)

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.